Testimony of Scott M. Naatjes
Vice President and General Tax Counsel
Cargill, Incorporated

United States Senate
Committee on Finance

Tax Reform Options: International Issues
September 8, 2011

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, I appreciate the opportunity to testify before you today on International Tax Reform.

My name is Scott Naatjes. I received my Juris Doctorate and Masters in Business Administration from Yale University, and my undergraduate degree in economics from Brigham Young University. I served as a law clerk to the Honorable Judge J. Daniel Mahoney of the United States Court of Appeals for the Second Circuit, worked at a large law firm, and have been a practicing tax attorney at Cargill for 15 years. I currently serve as Cargill's Vice President of Tax and General Tax Counsel. In that capacity, I am responsible for Cargill's global tax planning, compliance, audits, and controversies and oversee a staff of over 240 tax professionals in 30 different countries, most of whom are either CPAs or lawyers, and many of whom also hold graduate tax or business degrees.

In this testimony, I will provide a brief overview of Cargill and its place in the global market. I will then explain how our outdated international tax system and current academic and policy debates about that system fail to fully consider how the world has changed since the system was put in place. Finally, I will outline key principles that should govern efforts to reform U.S. international taxation policies and rules.

I will specifically address the following points:

1. The U.S. economy, wealth, and tax base grow both through capital deployed here and from capital deployed abroad but managed here. We need tax policy that is competitive and favorable to both.
2. Global capital markets are sufficiently large and liquid to ensure that competitive investments in every country will be funded, with or without U.S. MNCs.[1] U.S. international tax policy consequently cannot materially influence whether capital is deployed or business is conducted in a foreign country. It can only influence whether a U.S. MNC, a Foreign MNC, or a different investment vehicle will own or manage that business.
3. The global competition for managing capital invested and businesses conducted outside of the United States should be among the most important U.S. international tax policy considerations. When U.S. MNCs manage foreign investments and businesses, they create U.S. headquarters jobs, domestic economic synergies, and a larger U.S. tax base.
4. Most developed countries have adopted territorial tax systems that do not tax dividends or gains from the active conduct of foreign business operations of their MNCs, because they want to attract and strengthen their MNCs, attract capital from abroad, and create the headquarters jobs and synergies associated with managing a global enterprise in their country.

[1] A United States multinational corporation (or "***U.S. MNC***") is a multinational group of companies with a U.S. corporate parent company. A foreign multinational company (or "***Foreign MNC***") is a multinational group of companies with a non-U.S. corporate parent company.

5. The current U.S. worldwide tax system, anti-deferral rules, and expense allocation rules make U.S. MNCs inefficient investment vehicles for non-U.S. business opportunities.
6. Congress should enact a territorial tax system, reform subpart F,[2] and overhaul the expense allocation rules, all consistent with international norms.
7. Key international tax provisions that make the U.S. international tax system more competitive, such as section 954(c)(6),[3] are scheduled to expire in December. Congress should extend those provisions now while it considers tax reform.

Cargill

Background

Cargill is an international producer and marketer of food, agricultural, financial and industrial products and services. Founded in 1865, our company employs over 130,000 people in 63 countries. Nearly 50,000 of our employees reside in the United States, including approximately 5,000 who work in our headquarters offices located near Minneapolis, Minnesota. With annual sales of close to $120 billion and earnings close to $4 billion in our last fiscal year, Cargill is one of the largest private companies in the world and one of the largest U.S. MNCs.

The backbone of Cargill's global business is connecting farmers and ranchers with food companies and consumers. We help farmers grow and then take to market nearly anything that is produced on a farm or ranch, from grains and oilseeds, to palm fruit, cocoa beans and livestock. We turn those products into food and food ingredients that help nourish the world. Our products and services include animal nutrition and feed, commodity trading and processing, energy and transportation, farmer services, and financial and risk management. Many of the foods and ingredients you eat and use every day—from flour, meat and eggs, to cooking oils and sauces, to the specialty ingredients on your food or healthcare labels, like xanthan gum and carrageenans—are made by Cargill or from products Cargill buys and sells.

Cargill and the Global Market

Approximately 60% of Cargill's sales and income are from active business operations outside the United States. As the world outside the United States continues to increase its capacity to produce food and its population grows, Cargill's global footprint will also need to grow.

Like our competitors, we build grain elevators, crush facilities, food production plants, and port facilities around the globe. We compete for the opportunity to serve farmers, customers, consumers, and markets. We pay local taxes, including not only income taxes, but export taxes, value-added tax ("***VAT***"), and other excise and sales and use taxes. We also build roads, schools and infrastructure to support our investments and enhance the communities where we do business.

Many of our competitors are Foreign MNCs organized in jurisdictions with both low home-country income tax rates and territorial tax systems. Unlike our competitors, Cargill bears home-country tax burdens on its foreign income and investments. First, Cargill is subject to a second layer of income tax on our non-U.S. earnings when we repatriate those earnings to the United States. Second, the U.S. expense allocation rules create U.S. tax costs attributable to our non-U.S. investments even when we do

---

[2] Chapter 1, Subchapter N, Part III, Subpart F of the Internal Revenue Code of 1986, as amended (the "***Code***"). *See generally* sections 951 through 964. Unless otherwise noted or clear from the context, all references to "section" or "sections" in this document are to sections of the Code. All references to "Treas. Reg. §" are to sections of the Treasury Regulations promulgated under the Code.

[3] Section 954(c)(6) is the provision that exempts dividends, interest, and royalties paid from the active income of a non-U.S. affiliate from U.S. taxation under subpart F.

not repatriate earnings from those investments to the United States. Third, the U.S. subpart F rules make deploying and managing risk on our non-U.S. earnings expensive and complex. Those differences constitute a significant disadvantage to Cargill as it tries to compete in the global marketplace.

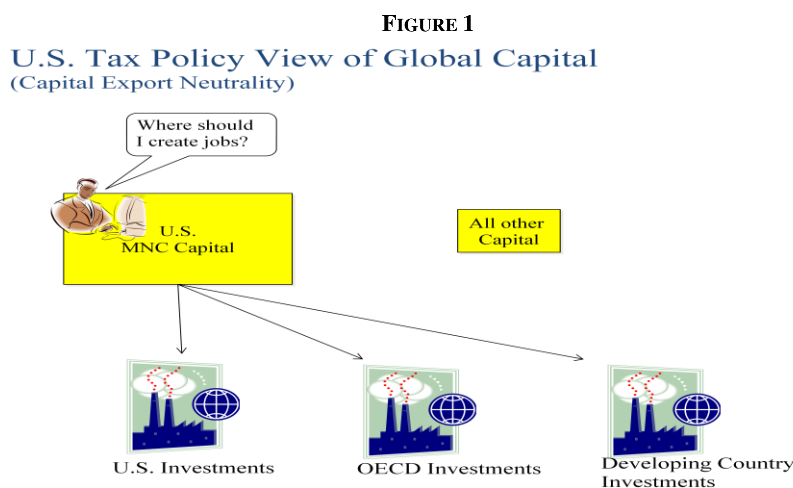
The Current U.S. Tax System and the Global Economy

A System for a World that No Longer Exists

The U.S. income tax system for non-U.S. income was adopted at a time when (i) the United States was the dominant provider of global capital and U.S. MNCs were a dominant vehicle for foreign direct investment ("***FDI***"); (ii) U.S. corporate income tax rates were equal to or lower than the tax rates of our trade partners; (iii) Foreign MNC competitors of U.S. MNCs were also subject to global income taxation; (iv) indirect tax and other local burdens were relatively immaterial; and (v) the United States had the most stable economy and currency and the best educated work force in the world.

Figure 1 illustrates the outdated conception of global capital investment that still drives U.S. tax policy today.

FIGURE 1



Much has changed. The United States, over the last five years, has provided approximately 20% of global FDI and represents a much smaller portion of total global capital available to fund non-U.S. investment opportunities.[4] U.S. corporate tax rates are nearly 15 percentage points higher than the average rates paid in EU and other OECD-member countries.[5] The United States stands nearly alone in its taxation of worldwide income. Indirect and other local non-income taxes such as the VAT have increased in importance and scope in almost every country. Finally, the economic strength of our Foreign MNC competitors continues to grow as global markets become more efficient. In today's world, our international income tax system puts us at a competitive disadvantage.

Several commentators have claimed that comparisons of global effective tax rates between U.S. MNCs and Foreign MNCs demonstrate that the U.S. tax system does not create a material disadvantage for U.S. MNCs. At the same time, they sometimes argue that if we adopt a territorial system, jobs and taxable income will flee overseas. But if our system does not prevent U.S. MNCs from matching their non-U.S. competitors' tax rates, then why would U.S. adoption of a territorial system change behaviors?

---

[4] Organization for Economic Cooperation and Development, "FDI in Figures," (Jul. 2011). Note that over the past five years roughly 65% of U.S. FDI has been made in OECD member countries. The U.S. stock of FDI abroad as of 2010 was roughly $3.6 trillion, less than 2% of the total amount invested through total global capital markets.

[5] European Commission Directorate-General for Taxation and Customs Union & Eurostat, "Taxation Trends in the European Union" (2011), p. 31. This comparison includes U.S. federal and state and local taxation.

On the other hand, if the current U.S. system effectively imposes burdens that hinder U.S. MNCs from growing abroad, then the system, by definition, makes companies like Cargill less competitive.

The reality is that the U.S. tax system puts U.S. MNCs, like Cargill, at a competitive disadvantage *vis-à-vis* our non-U.S.-based competitors. To succeed abroad, U.S. MNCs must maintain sufficient efficiencies and synergies to overcome the additional tax burden of our worldwide international tax system and in most cases pay a cadre of high-priced lawyers and CPAs to help them manage or defer the U.S. tax cost.

The United States cannot stand still or further expand its worldwide tax system and hope the rest of world will follow. The world has tried our dated tax model and abandoned it for a system that reflects the reality of today's global capital markets.

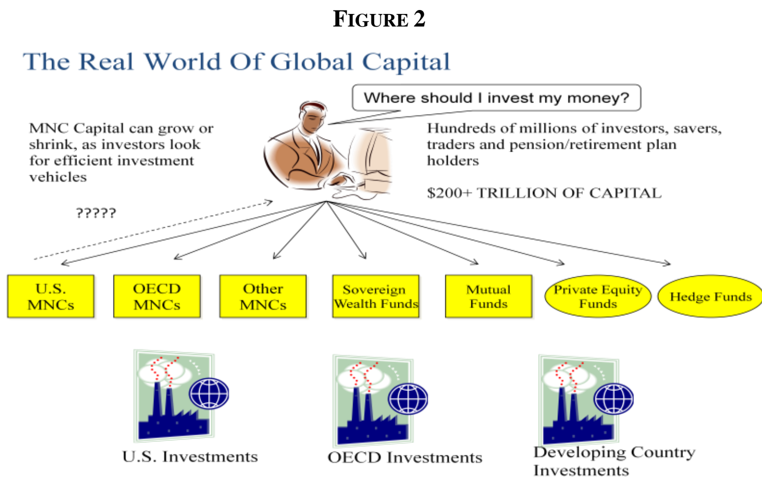
The Competition to Manage Capital in Today's Global Market

We live in a world in which barriers to capital mobility and international trade have diminished. If global trade agreements, labor markets, natural resources, business climate, regulatory environment, and cost structures make a country the optimal location for any particular investment, capital markets will ensure that investment is eventually made there.

The total wealth invested through global capital markets exceeds $200 trillion.[6] Approximately $80 trillion is held by funds, such as hedge funds, private equity funds, sovereign wealth funds, pension funds, and insurance funds.[7] Every competitive project in the world will be funded by someone—most likely someone from outside the United States.

Figure 2 illustrates how capital is actually allocated and invested today. U.S. MNCs are relatively small players in the rapidly expanding global capital market.

FIGURE 2



In this worldwide economy, U.S. MNCs like Cargill do not control the world's capital or dictate where it is invested. MNCs are not endowed with capital, they must compete for it. U.S. tax policy cannot materially influence whether soybeans will be grown and processed in South America, textiles will be fabricated in Central America, steel will be made in China, or electronics will be manufactured in Taiwan. U.S. tax policy can, however, determine whether U.S. MNCs, like Cargill, will be competitively positioned to attract or retain the capital to fund and manage such investment opportunities.

---

6 McKinsey Global Institute, "Mapping Global Capital Markets 2011," (Aug. 2011), p. 2.

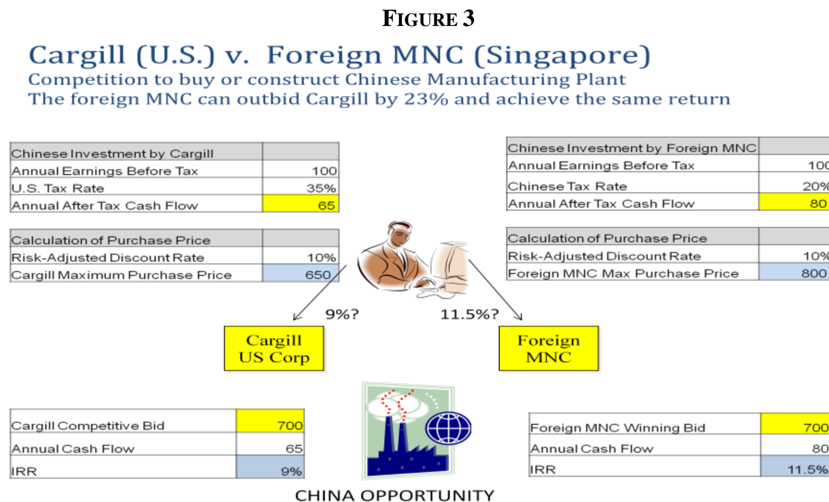
7 Marko Maslakovic, "Fund Management 2010," The City UK (Oct. 2010).

The U.S. Tax System's Impact on Competitiveness

A simple example illustrates the impact that the current U.S. tax system has on the ability of a U.S. MNC like Cargill to compete for capital and win acquisition contests.

Assume that a business expansion (the "***Investment***") is being explored by Cargill and a Foreign MNC in China that cannot be economically made in any other country. Assume that Cargill and the Foreign MNC each has a 10% required return on investment and would generate similar pre-tax returns from the Investment. Assume that local tax planning opportunities are available to all well-advised investors so that the profit from the Investment in China is expected to be taxed at approximately a 20% rate. Assume further that Cargill pays 35% U.S. income tax on the earnings from the project, with no deferral on the Investment's return, while the Foreign MNC would pay only the local 20% income tax rate, because it is located in a jurisdiction with a territorial system. As illustrated in Figure 3, Foreign MNC can outbid Cargill by roughly 23% and earn the same 10% rate of return. It could also match any bid offered by Cargill and achieve a higher return.

FIGURE 3



If Cargill upped its bid to 700 to try to compete, Foreign MNC could equal our bid and promise an after-tax rate of return 2.5 percentage points higher than Cargill's. Even if we assume that Cargill could defer its U.S. tax bill for 10 years and ignore all other possible U.S. tax costs under the U.S. expense allocation or subpart F rules, Foreign MNC could still outbid Cargill by over 13% and generate the same after-tax return.[8] Thus, the efficiencies and synergies of a U.S. MNC like Cargill relative to our Foreign MNC competitors need to be substantial to succeed in today's economy.

The Consequences of Not Bringing the U.S. Tax System into the 21st Century

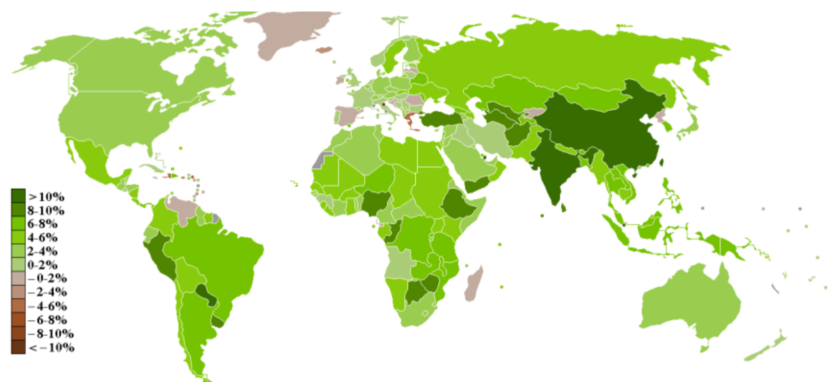
If the U.S. economy could sustain a 3% growth rate, it would double in roughly 25 years. Based upon current growth trends, India and China are expected to double in size every 7 years.[9] According to the *Economist*, in 1960, it took 20 years for one-third of the *Fortune* Global 500 (the "***Global 500***") to

[8] After 10 years, Cargill would have accumulated $800 of earnings & profits and $200 of income tax credits. The residual U.S. tax of $150 would be paid in year 10 [($800+$200 gross up) x 35% - $200 of credits = $150]. The present value (the "***PV***") of Cargill's cash flow for the first 10 years would be $434, using a discount rate of 10%. The PV of the $80 10-year annuity for Foreign MNC would be worth $492, using the same discount rate. This $58 differential is equal to 13.3% [($492-$434)/$434 = 13.3%].

[9] Central Intelligence Agency, World Factbook 2011 (2011). Map available at http://en.wikipedia.org/wiki/List of countries by real GDP growth rate (latest year).

change.[10] Today, it takes 4 years.[11]

FIGURE 4
Projected Global GDP Growth Rates



In just under 10 years, BRIC-based companies in the Global 500 nearly quadrupled, increasing from 16 to 58.[12] In contrast, the number of Japanese companies in the Global 500 declined by almost 40% during the last decade.[13] The number of U.K. companies declined by 25%.[14] Both countries responded by joining the rest of the world and abandoning their worldwide tax systems for territorial systems.[15]

FIGURE 5
Global 500 Corporations Resident in the U.S. & Key Trading Partners 2000 vs. 2009

	2000		2009		
Country	Number of Companies	Tax Rate	Number of Companies	Tax Rate[16]	Current Tax System
U.S.	179	39%	140	39%	Worldwide with Credit
Japan	107	43%	68	41%	95% Exemption (enacted in 09)
U.K.	38	30%	27	28%	100% Exemption (enacted in 09)
France	37	38%	40	34%	95% Exemption
Germany	37	52%	39	33%	95% Exemption
Korea	12	31%	14	22%	Worldwide with Credit
Switzerland	11	35%	15	24%	100% Exemption
China	10	33%	37	25%	Worldwide with Credit
Italy	10	40%	10	30%	95% Exemption
Netherlands	10	35%	12	25%	100% Exemption

There were 22% fewer U.S. MNCs in the Global 500 in 2009 than in 2000 (179 in 2000 vs. 140 in 2009).[17] The United States has responded, in part, by passing tax laws to prevent U.S. MNCs from expatriating.[18] This wall-building approach to a non-competitive tax system cannot stem the tide of global growth.

---

[10] Adrian Wooldridge, "Global Heroes," The Economist Newspaper, Mar. 14, 2009.

[11] *Id.*

[12] Barbara Angus, Tom Neubig, et. al., "The U.S. International Tax System at a Crossroads," 127 Tax Notes 45 at 56-57, Table 2 (Apr. 5, 2010).

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] 2010 top statutory tax rate, including subnational taxes.

[17] *Id.*

[18] *See* Brett Wells, "What Corporate Inversions Teach About International Tax Reform," 127 Tax Notes 1345 at 1351 (Jun. 21, 2010) (summarizing recent anti-inversion provisions).

For U.S. MNCs, maintaining the innovation and vision to compete and thrive in this rapidly changing world will be difficult. Asking them to do so while subject to current U.S. international tax policies would be imprudent.

Current Tax Policy Debates: Stuck in the Sixties

Is Offshore Growth by U.S. MNCs Synergistic with or a Substitute for U.S. Jobs?

Academics and policy makers spend a considerable amount of time worrying about whether overseas expansion by U.S. MNCs is synergistic with or a substitute for U.S. investment and employment.

The answer is interesting, but it is the wrong question. Since global capital markets will ensure that efficient non-U.S. investments are made with or without a U.S. MNC, the correct question is whether it will be relatively more synergistic to U.S. employment and the U.S. tax base to have the non-U.S. investment made by a U.S. MNC or Foreign MNC.

Even if the investment at issue is a non-U.S. manufacturing facility that supplants a U.S. manufacturing facility, U.S. employment and economic strength are enhanced if the investment is owned and managed by a U.S. MNC (rather than a Foreign MNC). Employment income and other economic synergies from managing non-U.S. invested capital and businesses create significant sources of revenue for the U.S. tax base (federal, state, and local) and make our U.S. enterprises stronger and more competitive. Almost all of our major trading partners have understood this reality and modified their tax systems accordingly.

Considerable sums of tax revenue are at stake. U.S. MNCs, like Cargill, maintain staffs of highly paid, highly educated, and uniquely skilled employees at headquarters in the United States. The charitable and educational organizations those employees support have helped create the civil society we enjoy, fund both basic and higher learning, and further important social causes.[19] The associated tax base for individual income tax, social security tax, sales and use tax, estate tax, and property taxes contributes materially to funding local and federal government activities. Income tax collections alone from Cargill's 5,000-person headquarters can equal several hundred million dollars in a single year.

In addition, expansion and acquisition outside the United States increase competitiveness and market intelligence. For Cargill, each successful expansion or acquisition adds to our overall efficiency. The knowledge arising from a presence in all corners of the global market provides us the business intelligence we need to compete and win. Enhanced competitiveness attracts capital. Management of that capital at U.S. headquarters, like ours in Minneapolis, creates high-paying, knowledge-based jobs and related support jobs that strengthen our economy and country.

In many cases, overseas expansion also (i) helps a U.S. MNC grow and profit from its U.S. intellectual property, (ii) creates economies of scale and cost efficiencies for its U.S. plants, (iii) provides access to non-U.S. markets for U.S. production, or (iv) creates knowledge that benefits all other markets. In other cases, a specific manufacturing or other business opportunity may simply be best-placed closer to suppliers or customers. In all cases, we are better off as a nation when our market-leading U.S. MNCs manage the non-U.S. investment and capital associated with those projects.

Misplaced Fear Regarding Transfer Pricing

Some academics and policy makers have also expressed concern that a territorial system will cause U.S. taxable income to artificially shift overseas through transfer pricing practices that cannot be

---

[19] Cargill's headquarters donations to United Way exceeded $4.5 million in 2010 alone.

adequately challenged by the Internal Revenue Service (the "***IRS***").

This concern is legitimate, but should be replaced by a more important consideration. MNCs are here to stay. In the long-run, we can choose either to be home to the headquarters of these far-flung and successful enterprises, or to become a host to satellite subsidiaries of large Foreign MNCs. Foreign MNCs rarely set up their headquarters here, even more rarely own their intellectual property here and only own their non-U.S. subsidiaries through the United States because of historical accident.

Transfer pricing controversies between governments and MNCs are unavoidable. By establishing an international tax system competitive with global norms, we can increase the likelihood that our future disputes will be primarily with U.S. MNCs, rather than Foreign MNCs that would otherwise replace them.[20] The arm's-length standard that governs transfer pricing is not perfect, but it is generally consistent with underlying business economics. The more the economics of a global MNC are controlled and managed from the United States, the greater our likelihood as a nation of enjoying a larger share of the MNC's income. We cannot fear a territorial system for U.S. MNCs because of transfer pricing. It is another reason to embrace it.

Trapped Cash: A Symptom of a Failed System

Commentators and policy makers widely view the large offshore cash reserves of many U.S. MNCs as a problem created by our international tax system. Some have then concluded that a worldwide tax system without deferral would solve the problem as effectively as a territorial system, because if all non-U.S. income is taxed at the time it is earned, there would be no tax at the time of repatriation, and therefore no disincentives to paying dividends.

This thinking misses the point. First, while it is true that a surgeon can eliminate the pain of an arthritic knee either through knee replacement surgery or by amputating the leg, the real issue is not the pain, it is mobility. We want our U.S. MNCs to be mobile and competitive, not permanently disabled. The trapped offshore cash is the symptom of the real problem: our antiquated tax system. Simply getting cash home through a more burdensome system only makes it worse.

Second, the offshore capital has not disappeared. It is deposited or invested with global financial institutions and markets. If a competitive project should be funded in the United States, the financial resources are available to any number of global competitors through those institutions and markets. In our current tax system, U.S. MNCs are less efficient than Foreign MNC competitors because they cannot nimbly deploy their cash and therefore service their creditors or shareholders around the globe. However, robust capital markets will ensure that the capital generally finds its way to the correct country. Again, our policy for taxing non-U.S. income will not drive the ultimate allocation of capital between countries. It will only determine whether U.S. MNCs can competitively manage that capital.

Finally, a U.S. MNC is not a repository for capital. It is simply a pass-through vehicle for shareholder capital. Once the cash is returned to the United States, to the extent capital markets are efficient, it is little more likely to be deployed in the United States than when it was deposited with a bank offshore.

The Effective Tax Rate: Important but Widely Misunderstood

The media routinely publishes sensational articles about low effective tax rates ("***ETR***"), often alleging that the United States' high statutory rates do not really matter since no company pays them or that U.S. MNCs are evading tax burdens globally. While a U.S. MNC's ETR, over time, is an important

[20] The IRS has full access to all financial information, legal documents, books, records, and key officers of the global enterprise and ***all*** of the records of a U.S. MNC's non-U.S. subsidiaries. Matching this advantage against a Foreign MNC may in some cases be difficult.

measure of its global income tax burdens, a few clarifications are needed.

First, ETR is a financial accounting concept. It measures income tax on U.S. GAAP income, not tax on U.S. taxable income. Differences between GAAP and taxable income frequently occur. Unless you know a company well, it is easy to misinterpret the significance of a low ETR in any given year. One company's ETR can be inflated by a non-deductible GAAP write-off. Another can have an artificially understated ETR because it wins a tax controversy for which it had taken a prior financial reserve or uses a tax credit or loss carry forward that it thought would expire.

Second, the U.S. GAAP rules in some cases are biased towards showing a low ETR. For example, a U.S. MNC is not required to accrue its future U.S. tax burden on non-U.S. earnings if it has no current plan or need to pay dividends.[21] But plans are uncertain things. A U.S. MNC's low ETR consequently has a material probability of being temporary, while a Foreign MNC with a territorial system is likely to have a low ETR that is permanent. U.S. MNCs might in some cases have ETRs that look like the ETRs of Foreign MNCs in territorial systems. But U.S. MNCs bear possible future tax burdens that Foreign MNCs do not. U.S. MNCs (unlike Foreign MNCs) also bear planning costs and structuring complexities due to those burdens, in addition to the costs related to the U.S. expense allocation rules or accelerated taxation under subpart F.[22]

Third, some have examined the U.S. effective income tax rate on non-U.S. income, erroneously ignoring the non-U.S. income taxes paid.

Fourth, each country in which an active business is conducted extracts sufficient resources from business to fund itself. ETR does not measure the full social burden of doing business. Whether the business system is burdened by a VAT, a wealth tax, an excise tax, social taxes on labor, withholding taxes, turnover taxes, export taxes, an income tax, or public works (including in some cases building roads, homes, utilities and schools),[23] no U.S. MNC running a real business outside the United States operates without helping to fund society. The fundamental error of using ETR as a measure of tax burden, and any worldwide tax system predicated upon ***income*** tax credits, is that it only takes into account one measure of the social burden.

Finally, the ***marginal*** tax rate on any given investment is what matters for planning purposes, not the ETR of the enterprise. For example, I am willing to pay more for a lower yielding municipal bond because the income earned is tax-exempt, than I would pay for a bond with otherwise equivalent terms. If I buy both, my ETR is lower than 35%, but the income from the taxable bond is still taxed a 35% rate, and I cannot buy it at an inflated price that assumes a lower rate if I want to stay in business.

---

[21] Accounting Principles Board, Opinion 23 (Apr. 1972), as amended and codified under ASC 740-30-25.

[22] There are many technical and economic complexities to the U.S. foreign tax credit rules that are beyond the scope of my testimony. One simple example is the unintended double taxation caused by the U.S.'s weak dollar policy. As the dollar devalues, U.S. MNCs bear additional U.S. tax to repatriate earnings because foreign taxes are translated to U.S. dollar in the year paid, while earnings are translated in the year repatriated. Whenever the dollar devalues against the currency of a foreign country, the effective foreign tax credit rate on earnings in that country declines. Paying a high foreign tax rate is no sure protection from double taxation.

[23] The economic burdens of various direct and indirect taxes are borne differently by capital, labor and consumers depending upon a host of local and global economic factors. But U.S. MNCs play a key role and bear real burdens for business and social taxes in many counties by acting as the reporting and withholding agents for governments, often at great cost and risk since the local rules are complex, the reporting requirements difficult, and any error leads to direct liability for not only the tax, but large penalties and high rates of interest. Failure by a few down-stream suppliers to remit VAT to the government can cost a U.S. MNC VAT credits that consume the entire profit from operations for an entire year. In many countries, local tax risks and economic burdens with respect to indirect taxes can be far greater than for income taxes. In some jurisdictions and markets, U.S. MNCs (and other large companies) compete against small local companies that routinely flout the rules, creating unfair competition and causing the U.S. MNCs to economically bear a large measure of the tax burden for what otherwise would be considered a pass-through tax.

Similarly, tax savings in one country cannot compensate for an unequal tax burden in another. A tax incentive in Thailand or a section 199 deduction[24] in the United States both lower a U.S. MNC's global ETR, but do not lower U.S. or local taxes on income earned in China. Stated differently, if my marginal tax cost in China is 35% while my competitor's is 20%, my tax incentive in Thailand or my section 199 deduction in the United States cannot make me more competitive in China. Thus, ETR matters over time and is evidence of efficiency, but it should not be mistaken for competitiveness on any given project or in any particular market.

Income tax is a cost, much like any other. Each investment must stand on the marginal revenues and costs (including tax) that it generates. Global success in business, due in part to lower taxes, may provide business synergies that make a project competitive in China, but a company cannot import its low offshore ETR.

In Cargill's case, we face competitors who routinely achieve ETRs more than 10 percentage points below ours. A material portion of this differential is driven by the U.S. worldwide tax system that burdens our competitive edge abroad.

Understanding Foreign Holding Companies (Rather than Demonizing Them)

Like most U.S. and Foreign MNCs, Cargill holds many of its non-U.S. operating companies through holding companies, some of which make and sell goods, but others that primarily hold capital interests (equity and debt) in other non-U.S. subsidiaries. These holding companies further many important commercial, treasury management and tax objectives. A number of popular misconceptions should be cleared up about such companies.

First, large U.S. MNCs like Cargill do not "hide" profits or cash in tax havens. U.S. MNCs like Cargill are subject to full disclosure of all activity and bank accounts associated with non-U.S. holding companies. The IRS annually receives for each non-U.S. controlled company full GAAP financial statements as well as a Form 5471, 8865 or 8858 that disclose the same types of information available from a company organized in the United States. In addition, any passive or portable income earned in those companies is subject to immediate U.S. taxation under our subpart F rules. Large U.S. MNCs (including Cargill) are under continuous audit by the IRS, during which all of that information is reviewed.

Second, in the case of a U.S. MNC like Cargill, the earnings and wealth of the holding companies is almost exclusively derived from dividends, interest, and royalties paid from active foreign business. Thus, although a holding company may not be paying significant tax in its local jurisdiction, all of the earnings distributed or paid to it were subject to the normal tax rules of countries where an active business is conducted.

Third, holding companies often play a vital role in global risk management, providing U.S. MNCs with protection through bilateral investment protection treaties and income tax treaties that reduce both non-U.S. operating and tax risks.

Fourth, because the U.S. tax system imposes a tax on dividend repatriation, U.S. MNCs must either bear the costs of U.S. taxation and complexities of the U.S. foreign tax credit rules, or leave excess equity in a foreign country. Over-capitalizing non-U.S. subsidiaries with equity increases country risks, foreign currency exchange risk, global funding costs, and foreign taxes.

U.S. MNCs like Cargill and their Foreign MNC competitors invest in risky countries where

[24] The "section 199 rules" provide a deduction for income attributable to certain domestic production activities.

currency controls, expropriation risk, and legal volatility necessitate capital mobility. Many of those countries are crucial to the world food supply, so Cargill, in order to compete in its market space, must have a presence in such places. If Cargill were unable to move its capital in and out of such countries when necessary without incurring home country tax costs, then it would be disadvantaged relative to its Foreign MNC competitors that face no such home-country tax costs.

Finally, every host country determines the total tax and social burden it places on a business enterprise. To compete in a country, a U.S. MNC can afford to pay and bear that tax and social burden, and no more. If a host country allows deductions for interest expense on debt equal to two-thirds or less of total capital and arm's-length royalty payments to offshore affiliates, then prudently structured companies will need to earn a portion of their return from business in that country through interest and royalty income offshore, to achieve a competitive return for their shareholders. Many Foreign MNCs in territorial systems can earn this income free of home-country tax. U.S. MNCs, like Cargill, need holding companies and other exceptions to general U.S. international tax rules to achieve that result.

Check-the-Box Rules and Section 954(c)(6)

The check-the-box rules and section 954(c)(6) look-thru rules allow U.S. MNCs, through holding companies, to capitalize non-U.S. operating subsidiaries and temporarily operate without imposition of U.S. tax in a manner similar to their Foreign MNC competitors. All of this planning has legal costs and risks. Repealing the check-the-box rules or failing to extend section 954(c)(6) would simply cause U.S. MNCs to pay more non-U.S. tax, which would actually (under our foreign tax credit rules) reduce U.S. tax revenues. At the same time, U.S. MNCs would incur significant internal and external costs and fees to restructure their operations in ways that seek to mitigate the loss of those provisions, in some cases moving back to more complex structures that existed prior to the enactment of those rules. Even Congressional reluctance to make section 954(c)(6) (and other international provisions) permanent forces U.S. MNCs to review and reconsider their structures each year in costly exercises that divert resources from more productive activities. Most Foreign MNCs do not bear similar costs.

Repealing the check-the-box rules or not extending the effective date of section 954(c)(6) would in the long-run cause U.S companies to pay more foreign tax and expose more capital to foreign risk, making U.S. MNCs less competitive in the global marketplace.

Over time, global capital markets will ensure that the most efficient enterprise manages the business and controls the capital, including the company that can use the optimal tax structure for a country. In the long-run, it benefits the United States if its companies are able to operate in a way that allows them to pay the same amount of non-U.S. tax as their Foreign MNC competitors.

Misguided U.S. Expense Allocation Rules

Consistent with international norms, every U.S. MNC must follow transfer pricing rules to recharge expenses of U.S. affiliates to non-U.S. affiliates that benefit from those expenses. Virtually every other country stops here. But the United States goes a step beyond and requires that the expenses of the U.S. affiliates that ***could not*** be recharged under an arm's-length standard nonetheless be considered related to the generation of non-U.S. source income under formulaic methods prescribed in nearly 100 pages of technical expense allocation rules.[25]

Under our foreign tax credit rules, no U.S. MNC can claim a single penny of foreign tax credits until it generates more non-U.S. source income than all of the formulaically allocated expenses. The foreign tax credit is then limited to 35% of the excess. For companies with significant domestic interest

---

25 *See* Treas. Reg. §§ 1.861-8 through -17.

expense, the annual expense allocation can easily exceed hundreds of millions of dollars in a single year. Until a company with this issue earns more non-U.S. source income in the United States than its allocated expenses, it cannot credit a single dollar of foreign income taxes, and any net deficit carries forward forever. Thus, a portion of that company's interest expense, U.S. management costs, and U.S. R&D expenses often become effectively non-deductible as the company expands outside the United States, even if it incurs greater proportionate expenses in its non-U.S. affiliates. As a result, marginal tax rates on non-U.S. source income are unpredictable and business planning is difficult for the U.S. MNC.

The worst of the formulaic expense allocation rules is our water's edge apportionment of interest expense that allocates U.S. interest expense to foreign source income based on the ratio of (i) non-U.S. assets in the U.S. group (including all retained earnings in non-U.S. companies) over (ii) total assets in the U.S. group.[26] Even if a U.S. MNC has relatively greater debt leverage and interest expense offshore, so that U.S. indebtedness could not be viewed as sustaining foreign operations, the U.S. rules disregard that fact and allocate interest expense to foreign source income anyway. In some cases, the interest expense allocation rules can have the perverse effect of making U.S. MNCs not only less competitive abroad, but at home, since their Foreign MNC competitors can borrow in the United States to fund a U.S. investment and deduct 100% of their interest expense against U.S. source income, while a U.S. MNC cannot.[27]

In 1992, former House Ways and Means Committee Chairman Rostenkowski stated that "[t]he proper apportionment of interest expense may be the number one tax problem for U.S. multinational corporations attempting to conduct business effectively abroad."[28] In 1999, the Chief Tax Counsel of DaimlerChrysler testified that the U.S. expense allocation rules were among the reasons they became a German company.[29] It has been 13 years. Little has changed. Congress passed a global interest expense apportionment rule in 2004, but its effective date continues to be postponed to raise tax revenue.[30]

Some have proposed keeping the U.S. expense allocation rules even if the United States adopts a territorial tax system, and then making the allocated expenses permanently non-deductible.[31] Not surprisingly, that could actually raise U.S. tax revenue relative to our current system. But it would do so with a tax cost based upon rules unrelated to non-U.S. income or business performance, making business planning more difficult and U.S. MNCs even less competitive.

The Burdens of Subpart F

The U.S. rules for currently taxing income earned by a non-U.S. corporation as though it were distributed to its U.S. shareholder are codified in subpart F of the Code. In my experience, they are the

---

26 *See* Treas. Reg. §§ 1.861-9 through 14T.

27 Note that there are also contrary examples. The point is that the interest expense allocation rules are un-economic, inconsistent with global norms, and create distortions.

28 138 Cong. Rec. H3817-03 (daily ed. May 27, 1992) (statement by Rep. Rostenkowski introducing H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act").

29 Hearing on Impact of U.S. Tax Rules on International Competitiveness before H. Comm. on Ways and Means, 106th Cong., 1st Sess. (June 30, 1999) (testimony of John L. Loffredo, Vice President and Chief Tax Counsel, DaimlerChrysler Corporation) ("The U.S. tax system puts global companies at a decisive disadvantage . . . In many cases, the U.S. taxpayer can NEVER fully utilize all of the foreign taxes paid by its subsidiaries to offset the U.S. tax on foreign earnings. The result is taxation of at least a portion of the earnings twice, by two countries. . . . The main reason for this problem is that a U.S. company has to apportion many of its domestic business expenses (especially interest expense) against its foreign source income.").

30 Section 864(f)(6) postpones the effective date to tax years beginning after Dec. 31, 2020. Although the provision was originally to come into effect for the first tax year beginning after Dec. 31, 2008, Sec. 3093 of the Housing Act of 2008 (Sec. 3093, PL 110-289, 7/30/2008) delayed the provision so that it was not to come into effect until the first tax year beginning after Dec. 31, 2010. Sec. 15 of the 2009 Assistance Act (Sec. 15, PL 111-92, 11/6/2009) further delayed the provision so that it was not to come into effect until the first tax year beginning after Dec. 31, 2017. The 2010 HIRE Act delays the effective date of the worldwide interest allocation election to tax years beginning after Dec. 31, 2020. (Code Sec. 864(f)(5)(D) as amended by 2010 HIRE Act sec. 551(a), Code Sec. 864(f)(6) as amended by 2010 HIRE Act sec. 551(a)).

31 *See*, e.g., Joint Committee on Taxation, "The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses," p. 10 (Jun. 22, 2006).

most far reaching, complex and punitive in the world. A few examples of situations where those rules overreach include the foreign base company sales and foreign base company services rules of subpart F that impose U.S. tax on active sales and services income regardless of the number of employees and assets directly employed in the business. Subpart F's foreign personal holding company rules measure passive income by specific category, making the capital loss or foreign exchange loss on a bond or share of stock non-deductible against the interest or dividend income of the very same bond or stock.[32] The rules allow no carryback or carryforward of losses except in special cases, and separate subpart F income from foreign tax credits if the foreign country has a mandatory tax year different from the rule mandated for U.S. reporting purposes. Timing and character issues create more confusion and difficulty. If the real ETR on a U.S. MNC's subpart F income is only 35%, it's a miracle.

Failed System Based upon Place of Incorporation

A Foreign MNC could maintain a headquarters in the United States without subjecting its non-U.S. affiliates to the United States' byzantine international tax rules. Some U.S. MNCs that expatriated prior to the tax law changes noted above have done so. This only proves the point that the U.S. international tax system is broken. If the parent company of a MNC group is organized in Bermuda (or any other country), no tax is imposed by the United States on income earned by its non-U.S. subsidiaries. If the parent company of the group is organized in Delaware, then all of the income of its non-U.S. subsidiaries will someday be taxed in the United States and, as noted above, it can never leave without incurring substantial tax costs.

Today, any tax advisor allowing a client to form a U.S. company for the purpose of owning non-U.S. subsidiaries needs to find a new career. An investor putting capital into a new U.S. corporation (that has not yet created global commercial synergies) to fund investments outside the United States may need a new financial advisor. When our largest and most important global companies are trapped in an international tax system that no one would choose and for which there are many good alternatives, it's time for a new tax system. We need not compel a slow death upon our largest and most venerated U.S. MNCs simply because of their historical accident of incorporating in the United States at a time when our tax system was competitive and there was a much smaller global marketplace.

Some might suggest that we tax companies based upon place of management to bring the non-U.S. income of Foreign MNCs into the U.S. tax net. But this would only put at risk their headquarters jobs too. We can't afford to lose the economic synergies created by MNCs' headquarters or the taxes paid by their employees.

At some point, the United States will need to face the fact that it cannot and should not collect tax on active income earned in a different country. We need to invite rather than repel global managers of MNCs.

The Future

The United States needs a competitive system for taxing non-U.S. income that follows world norms, including adopting a territorial system, repairing subpart F, and abandoning our expense allocation rules.[33] This is not a time for American exceptionalism.

---

[32] The passive income categories of section 954(c)(6) include (a) dividends, interest, royalties, rents, and annuities, (b) gains from property transactions, (c) gains from commodity transactions, (d) foreign currency gains, (e) income equivalent to interest, (f) income from notional principal contracts, etc.

[33] The worldwide norm for regulating interest expense deductions in both territorial systems and worldwide systems is to rely upon thin capitalization rules. I am not aware of another country that has adopted U.S.-style expense allocation rules. Some countries adopting territorial systems tax 5% of otherwise participation exempt earnings as a simple surrogate for expense allocation.

Some academics and policy makers continue to call deferral of U.S. taxation on active income of a U.S. MNC's non-U.S. subsidiaries a "subsidy" for moving jobs overseas, when other host countries to MNCs never tax such dividends and gains at all. We have also seen recent changes to long-standing international tax rules that allowed U.S. MNCs to compete abroad and proposals to enact many others. Rather than further weakening U.S. MNCs, Congress should extend key expiring international provisions like section 954(c)(6) now, while it considers overall tax reform.

The Difficulty with Revenue-Neutral Corporate Tax Reform

Meaningful tax reform that enhances the efficiency of our tax system and the future growth and strength of our economy will always have winners and losers. The objective for corporate and business tax reform consequently should not be revenue neutrality by type of tax, but distributional equality (or even greater progressivity) for Americans as a whole. The real goal is to fund our government as fairly and efficiently as possible.

Any changes we make to our system for taxing income earned outside the United States that makes us competitive in managing foreign business and capital will result in an overall U.S. tax reduction on non-U.S. income. It will create many positive effects for our economy and will expand other tax bases. But if such a reform were to keep overall corporate tax revenue neutral, it will shift some of the corporate tax burden to domestic source income, and thus to purely domestic business. This shift in tax burden to domestic U.S. business could reduce U.S. competitiveness with other countries to retain and attract the capital and businesses we want invested and built here in America. As a nation, we consequently may not be happy with either revenue-neutral international or domestic corporate income tax reform.

But the problems do not end here. Any base broadening we do to make a lower tax rate on domestic corporate income revenue neutral will eliminate business tax benefits also available for pass-through entities whose income is taxed to their owners at individual rates. Corporate tax reform that broadens the base and lowers the corporate tax rates will consequently increase the tax burden on domestic income to owners of pass-through entities, many of which are small businesses owners.

Thus, revenue-neutral corporate income tax reform may simply be a misguided idea.

Who Should Pay for International Tax Reform?

The burden of corporate income tax is borne by capital providers, employees, and consumers. Capital providers, employees and consumers may in some cases be the same people.[34] They may be wealthier or poorer than small business owners or grandmothers, but in every case, at the end of the day, they are people. The distributional effects of adjusting the business tax system can be adjusted through the manner in which we tax real flesh and blood individuals.

Thus, by proposing international tax reform, I am not suggesting that rich people pay less tax while poor people pay more. We need to design our tax system to maximize the economic pie that we, as Americans, all share, and then achieve our vision of fairness within that system. This could mean changes to individual tax rates and preferences, or even the types of tax we all pay.[35] These are hard

---

[34] We envision corporate income tax borne simply by business executives, Wall Street bankers, and other wealthy capital providers at our peril. The more accurate mental image may very well be a union employee. As capital and product markets globalize, labor's share of the corporate tax burden increases. The extent of this shift is hotly debated, but the direction is not. *See* William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office, August 2006.

[35] For example, it is difficult to find an economist who likes the economic impact of an income tax. A consumption, VAT, or sales tax that replaces parts of the income tax might be more favorable to our long-term economic prosperity. It could be designed to make the overall tax

issues for constituents to understand and difficult issues for economists to model, but they are critical to our long-term fiscal health. If meaningful tax reform were easy, economically or politically, we would have done it already.

Conclusion

U.S. MNCs do not need to expatriate, be acquired by a non-U.S. competitor, or invert for the era of the U.S. MNCs to end. In today's global economy, capital will migrate to those investment vehicles that can manage and integrate non-U.S. investments with the highest return.

With each non-U.S. investment opportunity lost, each acquisition of new capital by Foreign MNC competitors, and with the emergence of each new non-U.S. competitor with capital not subject to a U.S. tax burden, the U.S. MNCs' relative scale declines and future prospects darken. As U.S. MNCs decline, their domestic suppliers and partners suffer. Their highly compensated, highly skilled headquarters jobs and the associated base for income tax, social security tax, sales and use tax, and property taxes tied to managing a global enterprise diminish.

---

system equally or even more progressive than our current system. Again, if the overall type of taxation of any particular economic measure is inefficient, we can change it. We can then use rates and other types of tax to achieve our fairness goals.