TESTIMONY OF PROF. REUVEN S. AVI-YONAH
HEARING ON INTERNATIONAL TAX ISSUES

U.S. Senate Committee on Finance

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Chairman Baucus, Ranking Member Hatch, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Reuven Avi-Yonah and I am the Irwin I. Cohn Professor of Law and the Director of the International Tax Master of Law program at the University of Michigan Law School.

In this testimony, I would like to address options to reform the US international tax rules for both US corporations investing overseas ("outbound" taxation) and foreign corporations investing in the US ("inbound" taxation). I would like to make three points:

1. For outbound taxation, the preferred method of addressing the "lock out" problem is abolishing deferral while lowering the corporate rate to preserve competitiveness.
2. For inbound taxation, we should strengthen the thin capitalization rules and adopt other steps to preserve US taxing jurisdiction as the source country.
3. To police the boundary between US and foreign corporations, the definition of residence of US corporations should be changed to include all corporations managed and controlled from the US.

1. Outbound Taxation

Several current proposals to reform the US international tax regime envisage permanently exempting dividends from foreign subsidiaries of US-based multinationals from the income of their US parents. This is a somewhat limited version of territoriality because Subpart F would still apply to some passive income of those Controlled Foreign Corporations (CFCs) (although the current tax rules, particularly the check the box rules, seriously limit the effectiveness of Subpart F).

This type of limited territoriality has recently been adopted by the United Kingdom and Japan, so the US is one of the few members of the OECD to continue to tax its multinationals on world-wide income. Thus, it is argued that the US should follow suit to maintain the competitiveness of its multinationals and to prevent US-based multinationals from moving to other countries.

However, the territoriality issue is not relevant to competitiveness. To the extent that taxes influence competitiveness (which is primarily determined by other factors), the competitiveness of US-based MNEs is determined by the overall effective tax rate they face compared to the overall effective tax rate faced by multinationals based in our major trading partners. In particular, many of our competitor countries have much stricter CFC rules than the United States, so that their multinationals do not enjoy a competitive edge because of the limited territoriality that is allowed. Those who argue for territoriality for the United States, but who would leave today's holes in subpart F, are seeking much more than competitiveness – they are instead seeking a back-door exemption from the U.S. income tax that would cause U.S. multinationals to be taxed at much lower rates than the multinationals of competitive countries.

There is no good data indicating that the effective tax rate faced by US-based MNEs is significantly higher than that faced by MNEs based in other OECD countries. Moreover, there is reason to believe that the effective tax rate faced by US-based MNEs is **lower** than that faced by MNEs based in our trading partners. [1]

It is important that the much-overused word, "territoriality," not be misunderstood. Territoriality is about whether US-based MNEs will pay taxes on dividends distributed by their CFCs. Since US-based MNEs typically do not receive such dividends unless the US tax is covered by foreign tax credits, this tax has no impact on their competitiveness because they do not pay it. There is no reason to believe that US-based MNEs face any limitations in transferring funds either among their CFCs (since such transfers are now exempt from Subpart F), or on their ability to raise capital in the US. Most US MNEs are presently accumulating large amounts of cash, and they can easily access the capital markets for more, at very low interest rates. The territoriality debate has no impact on these funding decisions.

If competitiveness is not a reason to adopt territoriality, is there another reason? The answer is a qualified yes: Territoriality (i.e., exempting dividends from CFCs) can address the trapped income problem. US-based MNEs have a significant amount of foreign source income (as much as $1 trillion, based on financial statements) that they do not repatriate because it is earned in low-tax jurisdictions and will therefore trigger a US tax without foreign tax credit under current rules.

There are good reasons to believe that the trapped income problem is real. First, it is clear that US-based MNEs are leaving a lot of income permanently reinvested overseas. Second, when a temporary amnesty from the dividend tax was declared in 2004, over $300 billion in such earnings were in fact repatriated. Third, the IRS has been combating various schemes ("Killer Bs", "Deadly Ds" etc.) that were designed to repatriate foreign earnings while avoiding the dividend tax. These facts suggest

[1] Reuven Avi-Yonah and Yaron Lahav, A Comparison of the Effective Tax Rates of the Largest 100 US and EU Multinationals, paper to be presented at the American Tax Policy Institute Conference on International Taxation and Competitiveness, Washington, DC, October 17, 2011. For a summary of earlier literature reaching the same conclusion see Jane G. Gravelle, International Corporate Tax Rate Comparisons and Policy Implications, Congressional Research Service Report (March 31, 2011).

that the tax on foreign source dividends impacts behavior while collecting little revenue.

However, this does not mean we have to adopt territoriality. The trapped earnings problem would also be solved if we repealed deferral, since then the foreign earnings would be subject to current US tax and there would be no tax on repatriations. We could do this without affecting competiveness if we also reduced the corporate tax rate, as suggested by Senators Wyden and Coats in their tax reform proposal. Moreover, if we repealed deferral, our major trading partners may follow us, just like they followed us in adopting CFC legislation. The result would be a much better world, in which all major MNEs are subject to a single low tax on their worldwide earnings, without incentives to shift income to tax havens. The spread of CFC legislation (over 30 countries and counting) shows that there can be a race to the top in international tax, not just a race to the bottom.

In choosing between the two potential solutions to the trapped income problem (territoriality and ending deferral with a lower rate), the key consideration has to be protecting the US domestic corporate tax base. The main problem with territoriality is that it will significantly increase the incentives to shift income to low-tax jurisdictions. Currently, US-based MNEs know that such income shifting will result in more trapped income, and so they leave some income in the US. If there is no tax on dividends and foreign source income is exempt, the pressure on transfer pricing and the source rules will increase exponentially.

But what about our trading partners? The key point here is that our major trading partners in fact tax foreign source income more than we do, because their CFC rules are stricter. The typical CFC rules in the OECD, including the UK and Japan as well as the large continental European countries, take into account the effective tax rate in the source jurisdiction while determining whether the parent must include the income on a current basis. Thus, in our major trading partners, if (a) the source country has a low effective rate and (b) the CFC has no real business activities in that source country, the result is current taxation.

Our Subpart F, especially with the recent (post 1994) additions, is much more porous. It does not take the effective foreign tax rate into account (except to exclude "high taxed" income, which almost never happens) and it counts as "active" financial income and royalty income that can easily be earned in tax havens. Moreover, Subpart F (IRC 954(c)(6)) actively encourages the artificial shifting of income from high to low tax jurisdictions. As a result, despite our "world-wide" system and our trading partners' "territorial" system, **our major trading partners tax the foreign source income of their MNEs more than we do**.[2] That is the reason they could

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[2] Avi-Yonah and Lahav, supra.

adopt territoriality without fearing too much income shifting, and also the reason US MNEs never migrate to any of our major trading partners.[3]

If we adopt territoriality without reforming Subpart F, the source rules (e.g., the passage of title rule) and transfer pricing, the result will be a significant erosion of the US domestic corporate tax base. Deferral is already one of our largest corporate tax expenditures ($114.2 billion over 10 years).[4] We cannot afford to expand it further by converting it to an exemption, and the best course would be to get rid of it altogether in the context of an overall corporate tax reform. Such a reform should be done in a revenue neutral manner, and if the corporate rate is set low enough (e.g., 25%), it should not adversely affect the competitiveness of US-based multinationals.[5]

2. Inbound Taxation

Several recent studies have pointed out that while the US imports more capital than it exports, our international tax rules have focused primarily on preventing outbound profit shifting and paid insufficient attention to protecting the US corporate tax base when it is the source jurisdiction.[6] Thus, US subsidiaries of foreign multinationals are typically able to avoid paying significant amounts of US tax, while exploiting the US market.

There are several reasons for this problem:

a. The thin capitalization rule (section 163(j)) is too generous and enables US subsidiaries of foreign multinationals to eliminate up to

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[3] Japan, for example, recently adopted much stricter CFC rules which tax all undistributed profits of a CFC if it is subject to an effective tax rate of less than 20%. Germany eliminated accelerated depreciation, made local taxes not deductible for federal tax purposes, and imposed an "interest barrier rule" under which interest expense incurrent by a German parent corporation is deductible only if the parent on a standalone basis is no more highly leveraged than its CFCs. Brazil has completely abolished deferral since 2002. See papers by Takeshi Fujitani, Friedhelm Jacob and Linneu Mello, to be presented at the ATPI conference, supra.
[4] Estimate by the joint Committee on Taxation as reported in Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (March 10, 2011).
[5] The average effective tax rates for our major trading partners (weighted by the size of their economies) range from 27.2% to 28.7%. Gravelle, supra, summarizing earlier studies. As noted above, in most cases these effective rates reflect current taxation of low-taxed foreign source income of their CFCs. According to Gravelle's calculations, eliminating corporate tax expenditures and repealing the 2003 rate reductions for dividends and capital gains would permit a revenue neutral 10% reduction in the corporate tax rate. Gravelle, supra, Table 10.
[6] See. e.g., Bret Wells and Cym Lowell, Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin, Tax L. Rev. (2011, forthcoming).

half their gross income via the interest deduction, with no withholding under our tax treaties.

b. There is no limit to the ability of US subsidiaries to pay deductible royalties to their foreign parents, again with no withholding under our treaties. Transfer pricing enforcement in this regard is not helpful because it is virtually impossible to find adequate comparables.
c. In general, the transfer pricing rules are enforced more strictly in the outbound than in the inbound context, and most of the IRS resources are devoted to outbound transfer pricing.
d. The ability of foreign multinationals to sell their US subsidiaries at a gain without paying US or foreign tax (e.g., the current sale of T-Mobile by Deutsche Telekom to AT&T) is another way of avoiding tax on what is economically US source income.[7]

One possibility to address this issue is to levy a compensatory base protecting surtax whenever deductible payments (including cost of goods sold) erode the US inbound tax base beyond a given point.[8] Alternatively, we could take several smaller steps:

1. The thin capitalization rules should be strengthened by imposing an overall debt to equity limit (e.g., 3 to 1), which is the thin capitalization rule adopted by most of our major trading partners.
2. The same limit could be applied to royalties.
3. Transfer pricing resources should be devoted to inbound as well as to outbound transactions. If we abolished deferral as suggested above, all the IRS transfer pricing resources could be devoted to this issue.
4. The US should impose tax on inbound capital gains of large participations, like many of our most important trading partners (e.g., China and India). US treaty policy should be changed to permit this.[9]
5. We should reconsider our treaty policy of being more residence oriented than the OECD model. Given that we are the world's leading capital importer and are likely to remain so for a long time, a more balanced approach that permits for example withholding

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[7] See Reuven S. Avi-Yonah, Money on the Table: Why the U.S. Should Tax Inbound Capital Gains, 63 Tax Notes Int'l 41 (July 4, 2011).
[8] Wells and Lowell, supra.
[9] The following US treaties permit source taxation of capital gains from the sale of large participations: Australia, Bulgaria, Chile, China, India, Israel, Jamaica, Kazakhstan, Mexico, Norway, Russia, Spain, Sri Lanka, Thailand, Trinidad and Tobago, Turkey. In all of those cases, under our current rules the other country gets to tax these capital gains but we do not.

on interest paid to related parties (as in the OECD model) should be considered.

3. Corporate Residence.

In the new version of his Stop Tax Haven Abuse Act, Senator Levin once again proposed to modify the definition of residence for domestic corporations (IRC 7701). Section 103 of the Act seeks to "[s]top companies run from the U.S. claiming foreign status by treating foreign corporations that are publicly traded or have gross assets of $ 50 million or more and whose management and control occur primarily in the United States as U.S. domestic corporations for income tax purposes."[10]

This is not a new suggestion: In response to the inversions of the early 2000s, the Joint Committee on Taxation made a similar proposal.[11] Moreover, the "managed and controlled" test is well established in the jurisprudence of our trading partners (e.g., the UK) and is similar to the "place of effective management" which is included in all tax treaties based on the OECD model (e.g., in Article 8).

The original point of the managed and controlled proposal was to combat inversions, i.e., artificial migrations of US companies to offshore locations such as Bermuda. However, it is not clear that managed and controlled is necessary to combat inversions, for two reasons. First, IRC 7874 was enacted in 2004 and puts significant roadblocks in front of inversions, although it has loopholes that can be exploited. Second and more importantly, recent empirical research suggests that inversions are difficult for most US companies for both tax and non-tax reasons (e.g., shareholder reluctance to switch Bermuda for Delaware law for corporate governance purposes).[12]

Does "managed and controlled" still have a role to play in US tax policy if it is not needed to stop inversions? In my opinion the answer is a resounding yes. As Willard Taylor has shown, shell corporations are ubiquitous in US inbound and outbound international tax planning.[13] Adopting "managed and controlled" would be a significant deterrent to this type of planning, because it would require all foreign corporations to be actually run from abroad to avoid being re-defined as US

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[10] Stop Tax Haven Abuse Act, S. 1346, section 103, 2011 WTD 134-37.

[11] Staff of the Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, TA Doc. 2005-1714 (Jan. 27, 2005). For the history of the idea see generally NYSBA Tax Section, Report on the Management and Control Provisions of the International Tax Competitiveness Act of 2011, 2011 TNT 21-22 (Jan. 31, 2011).

[12] Eric Allen and Susan Morse, Firm Incorporation Outside the U.S.: No Exodus Yet (2011).

[13] Willard Taylor, "Blockers", "Stoppers", and the Entity Classification Rules, 64 Tax Law. 1 (2010).

corporations.

A recent UK case illustrates some of the anti-abuse potential of "managed ad controlled."[14] In that case, a Netherlands company was owned by a UK non-domiciled individual, who also served sometime as director (but not at the time of the relevant transaction). The UK CFC rules were inapplicable because the individual was not a UK resident for tax purposes. The Board met overseas and had full legal control of the company. Nevertheless, the UK court (including Commissioner John Avery Jones, a very tax-sophisticated judge) found that because the UK shareholder exercised de facto control of the company it was managed and controlled from the UK, and therefore was resident in the UK for tax purposes.

Imagine the consequences of adopting such a de facto control test in the US. It would further deter inversions, and would make it difficult for US-based hedge funds and nonprofits to use "blockers" to avoid effectively connected income and UBTI without actually operating the blockers offshore.[15] These are significant improvements over the current system.

But the biggest impact will be on Subpart F. If we abolished deferral, Subpart F would be unnecessary. But realistically, the debate between opponents and proponents of deferral and territoriality seems unlikely to produce real reform anytime soon. If we adopted "managed and controlled", however, it would become much more difficult for US multinationals to avoid Subpart F merely by creating shell companies overseas and using one of the myriad loopholes in the existing rules.

To name some recent examples: Microsoft and Google would have to really run their Irish, Dutch and Bermuda CFCs from those countries to avoid having them recharacterized as US corporations. Caterpillar would not be able to avoid the base company rule by putting a shell operation in Switzerland while running the actual buying and selling of spare parts from Peoria. Using IRC 954(c)(6) to shift profits from high to low tax countries overseas (which in turn encourages shifting from the US to the high tax ones) would become much more difficult because the tax haven subsidiaries would really have to be run from the tax havens.

No loophole closer is ever perfect. There will, of course, be situations in which the tax benefit is so great that companies will in fact pay executives the extra compensation needed to persuade them to live in Bermuda. But in many other cases the hassle will be too much. I worked on a transaction once in which the entire carefully planned tax structure was jeopardized by the unwillingness of the designated CEO of an offshore joint venture to live outside the United States. Moving people is harder than creating corporate shells.

Recent news reports as well as the careful Joint Committee study of transfer pricing

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[14] Laerstate BV v. Commissioners, [2009] UKFTT 209 (TC).
[15] See Taylor, supra.

from last summer have shown the extent of tax avoidance by US multinationals.[16] As stated above, the best solution would be to abolish deferral in conjunction with lowering the corporate tax rate. A second best solution would be to condition deferral on the foreign tax rate being about as high as the US rate.[17] But in the absence of such major reform, Congress would be well advised to at least adopt the managed and controlled test for US corporate residency. Such a test would make corporate tax avoidance by US multinationals significantly more expensive for the actual individuals who make the decisions to engage in such behavior. As indicated by the outcry against the personal responsibility provisions of Sarbanes-Oxley, putting the onus personally on the decision makers is the best deterrent.

[16] Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 (July 20, 2010).
[17] See Reuven S. Avi-Yonah, Testimony on Territoriality and Competitiveness, House Ways & Means Committee, May 24, 2011.