S. HRG. 114–230

BUILDING A COMPETITIVE U.S. INTERNATIONAL TAX SYSTEM

HEARING

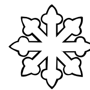
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

MARCH 17, 2015



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PUBLISHING OFFICE

99–718—PDF WASHINGTON : 2016

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON FINANCE

ORRIN G. HATCH, Utah, *Chairman*

CHUCK GRASSLEY, Iowa
MIKE CRAPO, Idaho
PAT ROBERTS, Kansas
MICHAEL B. ENZI, Wyoming
JOHN CORNYN, Texas
JOHN THUNE, South Dakota
RICHARD BURR, North Carolina
JOHNNY ISAKSON, Georgia
ROB PORTMAN, Ohio
PATRICK J. TOOMEY, Pennsylvania
DANIEL COATS, Indiana
DEAN HELLER, Nevada
TIM SCOTT, South Carolina

RON WYDEN, Oregon
CHARLES E. SCHUMER, New York
DEBBIE STABENOW, Michigan
MARIA CANTWELL, Washington
BILL NELSON, Florida
ROBERT MENENDEZ, New Jersey
THOMAS R. CARPER, Delaware
BENJAMIN L. CARDIN, Maryland
SHERROD BROWN, Ohio
MICHAEL F. BENNET, Colorado
ROBERT P. CASEY, Jr., Pennsylvania
MARK R. WARNER, Virginia

CHRIS CAMPBELL, *Staff Director*
JOSHUA SHEINKMAN, *Democratic Staff Director*

CONTENTS

OPENING STATEMENTS

Page

Hatch, Hon. Orrin G., a U.S. Senator from Utah, chairman, Committee on Finance 1
Wyden, Hon. Ron, a U.S. Senator from Oregon 3

WITNESSES

Olson, Hon. Pamela F., U.S. Deputy Tax Leader and Washington National Tax Services Leader, PricewaterhouseCoopers LLP, Washington, DC 5
Smith, Anthony, vice president of tax and treasurer, Thermo Fisher Scientific, Inc., Waltham, MA 7
Altshuler, Rosanne, Ph.D., professor of economics and dean of social and behavioral sciences, Rutgers University, New Brunswick, NJ 8
Shay, Stephen E., professor of practice, Harvard Law School, Harvard University, Cambridge, MA 10

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Altshuler, Rosanne, Ph.D.:
- Testimony 8
- Prepared statement 37

Hatch, Hon. Orrin G.:
- Opening statement 1
- Prepared statement 43

Olson, Hon. Pamela F.:
- Testimony 5
- Prepared statement 44

Portman, Hon. Rob:
- "Tax Inversion Curb Turns Tables on US," by David Crow, James Fontanella-Khan, and Megan Murphy, *Financial Times,* March 15, 2015 56

Shay, Stephen E.:
- Testimony 10
- Prepared statement 57

Smith, Anthony:
- Testimony 7
- Prepared statement 63

Wyden, Hon. Ron:
- Opening statement 3
- Prepared statement 67

COMMUNICATION

The LIFO Coalition 69

BUILDING A COMPETITIVE U.S. INTERNATIONAL TAX SYSTEM

TUESDAY, MARCH 17, 2015

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

The hearing was convened, pursuant to notice, at 10:11 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Crapo, Roberts, Thune, Portman, Coats, Heller, Scott, Wyden, Schumer, Stabenow, Cantwell, Menendez, Carper, Cardin, Brown, Bennet, and Warner.

Also present: Republican Staff: Mark Prater, Deputy Staff Director and Chief Tax Counsel; Eric Oman, Senior Policy Advisor for Tax and Accounting; Tony Coughlan, Tax Counsel; and Jim Lyons, Tax Counsel. Democratic Staff: Joshua Sheinkman, Staff Director; Tiffany Smith, Senior Tax Counsel; and Todd Metcalf, Chief Tax Counsel.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will now come to order.

I want to welcome everyone to today's hearing on Building a Competitive U.S. International Tax System. I also want to thank our witnesses for appearing before the committee today.

Reforming our international tax system is a critical step on the road toward comprehensive tax reform. Not surprisingly, the failures of our current system get a lot of attention. That is why Senator Wyden and I designated one of our five tax reform working groups to specifically look into this issue. I know that my colleagues serving on that working group, and all of our working groups, are looking very closely at all the relevant details, and I look forward to their recommendations.

As we look at our international tax system, our primary goals should be to make the U.S. a better place to do business and to allow American job creators to more effectively compete with their foreign counterparts in the world marketplace. Our corporate tax rate has been the highest in the developed world, and effective tax rates facing U.S. corporations are higher than average. In my opinion, our high corporate tax rate has to come down significantly.

I think most of my colleagues on both sides of the aisle would agree with that. In addition, our current system creates disincentives that lock out earnings made by U.S. multinationals abroad

and keep those earnings from being reinvested domestically. This also needs to be addressed in tax reform.

Additionally, I will note that the tax base is much more mobile than it used to be. For example, thanks to advances in technology and markets, capital and labor have become increasingly more mobile.

The most mobile assets of all, intangible assets, have taken up the greater share of wealth around the world. The problem we have seen is that intangible assets and property can easily be moved from the United States to another country, particularly if that country has a lower tax burden.

This is a disturbing trend, one that I think all of us would like to see reversed. Some, like President Obama in his most recent budget, have responded to this trend by calling for higher U.S. taxation of foreign-source income, claiming that by extending the reach of U.S. taxes, we can eliminate incentives for businesses to move income-producing assets to other countries.

The problem, of course, is that assets are not the only things that can be moved from one country to another. Companies themselves can also migrate away from our overly burdensome tax environment. We have seen that, with the recent wave of inversions, that has really been the case.

Indeed, many companies have already decided that our current regime of worldwide taxation with absurdly high tax rates is simply too onerous and have opted to locate their tax domiciles in countries with lower rates and territorial tax systems. In other words, if we are serious about keeping assets and companies in the United States, we should not be looking to increase the burdens imposed by our international tax system. Instead, we should be looking to make our system more competitive.

Not only must our corporate tax rate come down across the board, we should also shift significantly in the direction of a territorial tax system. Most witnesses have testified that way. If we want companies to remain in the U.S. or to incorporate here to begin with, we should not build figurative or legal walls around America. We should fix our broken tax code.*

[The prepared statement of Chairman Hatch appears in the appendix.]

The CHAIRMAN. We have a lot to discuss here today. I know that there are some differing opinions among members of the committee on these issues, particularly as we talk about the merits of a worldwide versus a territorial tax system. But I think we have assembled a very good panel that will help us get to some answers on this front and hopefully aid us in our efforts to reach consensus as we tackle this vital element of tax reform.

Let me just turn to our ranking member, Senator Wyden.

---

*For more information, *see also,* "Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income," Joint Committee on Taxation staff report, March 16, 2015 (JCX–51–15), *https://www.jct.gov/publications.html?func=startdown&id=4742.*

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you very much, Chairman Hatch. I think this is a particularly important hearing, and I look forward to working with you and the working groups on this and the other topics in a bipartisan way.

Colleagues, 9 months ago the Finance Committee gathered in this room for a hearing on how the broken U.S. tax code hurts America's competitiveness around the world, how that tax code is hindering the drive to create what I call red, white, and blue jobs that pay strong middle-class wages.

That discussion was dominated by the wave of tax inversions that was cresting at the time, pounding our shores and eroding our tax base. Headline after headline last summer announced that American companies were putting themselves on the auction block for foreign competitors. They would find a buyer, headquarter overseas, and then shrink their tax bills to the lowest possible level.

In the absence of comprehensive tax reform from the Congress, the Treasury Department undertook extraordinary measures aimed at slowing that erosion. Nine months later, the Finance Committee is back for yet another hearing on international taxation, and the headlines are back once more.

Once again, there is a wave cresting, and this wave is even bigger. Now it is foreign firms circling in the water and looking to feast on American competitors, often in hostile takeovers. Just like before, American taxpayers could be on the hook, subsidizing these deals. So there is an obvious lesson here. I see my friend from Indiana, Senator Coats, here. We have talked about this often.

Our tax code is deeply broken. The next flaw that exposes itself, the next wave that appears on the horizon, may not be about inversions or hostile takeovers. But whenever one wave breaks, you can bet that there will be another one rolling in, ready to pound the American economy and erode the American tax base even more. The deal makers are always going to get around piecemeal policy changes. Nothing short of bipartisan, comprehensive tax reform, in my view, is going to end that cycle.

Now, there has been an awful lot of ink spilled on the business pages and in magazines about the many ways our tax code is outdated and anti-competitive. The corporate tax rate puts America at a disadvantage. The system of tax deferral blocks investment in the United States like a self-imposed embargo. How fitting it is on St. Patrick's Day to shine a spotlight on mind-numbing strategies like the "Double Irish with a Dutch Sandwich" that is used to winnow down tax bills.

A modern tax code should fight gamesmanship and bring down the corporate rate to make our businesses more competitive in the tough global markets. That's what our bipartisan proposal would do. In fact, it has the lowest rate of any proposal on offer.

Colleagues, it is legislative malpractice to sit by and let this situation fester. The Congress cannot expect the Treasury Department to keep playing whack-a-mole with every issue that pops up. The latest wave of cross-border gamesmanship shows that cannot work.

So the Finance Committee is going to need to lead the way on tax reform. In my view, our end goals are bipartisan: a tax code

that supercharges American competitiveness in tough global markets; draws investment to the United States; and creates high-skill, high-wage jobs in Oregon and across the country.

It is going to take a lot of work and a lot of bipartisan will to get there, but, in the meantime, the waves are going to keep crashing, and our tax base is going to keep eroding. So it ought to be clear to all what our challenge is. I thank our witnesses today. I think this is going to be a fruitful discussion.

Mr. Chairman, I thank you again. I think we have seen how important it will be to have a bipartisan approach here, and I look forward to working with you.

The CHAIRMAN. Well, thank you, Senator.

[The prepared statement of Senator Wyden appears in the appendix.]

The CHAIRMAN. We have an excellent group of witnesses today. Let me introduce them. Our first witness is Pam Olson. She is the Deputy U.S. Tax Leader for PricewaterhouseCoopers, as well as PWC's leader for the Washington National Tax Services. Ms. Olson received her bachelor's degree, her Juris Doctor, and MBA from the University of Minnesota.

Prior to joining PWC, Ms. Olson was a partner with the law firm of Skadden, Arps, Slate, Meagher, and Flom. She also served as Assistant Secretary of the U.S. Treasury for Tax Policy from 2002 to 2004. We welcome you back. We have always enjoyed having you come and visit with us in this committee.

Our next witness is Tony Smith. I am just going to introduce all of you at once. Mr. Smith is the vice president of tax and treasurer at Thermo Fisher Scientific. He has more than 20 years of experience in global tax treasury operations and, of course, pension investments. Before joining Thermo Fisher Scientific, Mr. Smith was a partner at PricewaterhouseCoopers, as well as a partner at Pannell, Kerr, and Forster.

Mr. Smith holds a bachelor's degree in Economics from Loughborough in the U.K. and is a U.K.-chartered accountant. That is pretty impressive to me. We are glad to have you here.

Our next witness is Roseanne Altshuler. Dr. Altshuler is the dean of social and behavioral sciences at Rutgers University. Her research focuses on Federal tax policy, and her work has appeared in numerous journals and books. Dr. Altshuler holds a bachelor's degree from Tufts University and a Ph.D. in economics from the University of Pennsylvania.

Dr. Altshuler was formerly an assistant professor at Columbia University and a visiting professor at Princeton University and New York University. These are great credentials. She was formerly the editor of the *National Tax Journal* and a member of the board of directors at the National Tax Association.

Our final witness is Stephen Shay. Mr. Shay is a professor of practice at Harvard Law School. He has extensive experience in the international tax area and has been recognized as a leading practitioner by various organizations. Mr. Shay graduated with his master's from Wesleyan University, and he earned his J.D., Juris Doctor, and MBA from Columbia University.

Prior to joining Harvard Law School, Mr. Shay was a tax partner at Ropes and Gray, LLP for over 20 years and served as Deputy

Assistant Secretary for International Tax Affairs at the U.S. Treasury. So we feel very honored to have all four of you here with us today, and we look forward to your testimony.

So we turn to you, Ms. Olson, as the first witness.

STATEMENT OF HON. PAMELA F. OLSON, U.S. DEPUTY TAX LEADER AND WASHINGTON NATIONAL TAX SERVICES LEADER, PRICEWATERHOUSECOOPERS LLP, WASHINGTON, DC

Ms. OLSON. Thank you, Chairman Hatch, Ranking Member Wyden, distinguished members of the committee. I appreciate the opportunity to appear as the committee considers the important topic of the competitiveness of our international tax laws.

I should say that I am here today on my own behalf and not on behalf of PWC or any client, and the views I express are my own. I have submitted a longer statement for the record, which I assume will be included, Mr. Chairman?

The CHAIRMAN. It will be included in the record.

[The prepared statement of Ms. Olson appears in the appendix.]

Ms. OLSON. Thank you.

I agree with both your and Senator Wyden's opening comments. It seems particularly appropriate that the committee chose to hold this hearing on St. Patrick's Day, given Ireland's competitive tax system. As one of my colleagues has been known to joke, the U.S. has had a patent box for years: we call it Ireland.

Reform of our international tax rules is essential to growth of the U.S. economy and to the success in today's global marketplace of American businesses, their workers, and the many businesses on which they depend for goods and services. Unfortunately, our current system is a barrier to their success and is driving business away.

This morning I would like to highlight some of the changes in the global economy and in other countries' tax systems that I think make U.S. reform important. First, the U.S. has had a worldwide tax system since the inception of the income tax in 1913. The last significant change to our international framework was the enactment of the anti-base erosion provisions of subpart F in 1962.

Our international rules remain locked in a time of rotary phones and telephone operators, while we carry smartphones with 1,000 times the computing power of the Apollo guidance computer that put man on the moon. Meanwhile, global business operations and the global economy have changed significantly in the last 50 years. Advances in communication, information technology, and transportation have accelerated the growth of a worldwide marketplace for goods and services. The U.S. tax system simply does not position U.S.-based companies to serve it well.

The U.S. role in the global economy has also changed. In 1962, the U.S. was the dominant economy, accounting for over half of all multinational investment in the world. By contrast, PWC projects that by 2050 the combined GDP of the seven largest emerging economies will be twice the size of the combined GDP of the G–7. As President Obama noted in his State of the Union address, 95 percent of the world's customers live outside the United States. U.S. businesses cannot serve those rapidly growing markets by staying home.

Just as the global economy has changed, tax systems around the world have evolved in response to the growing importance of IP, the reorganization of economic activity across national borders, and the mobility of capital. Other countries have reduced their statutory corporate income tax rates, added incentives for research and development, and adopted territorial systems that limit the income tax to activities within their borders, all in order to attract the capital and IP that yield high-paying jobs.

Other countries rely more heavily on consumption-based taxes, such as a value-added tax or goods and services tax, to fund government needs, giving them a base that is more reliable, more easily measured, less mobile, and more conducive to economic growth. By contrast, the U.S. has the highest statutory income tax rate among major global economies and a high effective tax rate relative to our competitors. At the same time, other countries have adopted generous incentives for patents and innovation to attract research and development activities.

Our currently expired U.S. research credit is ranked 27th out of 41 countries in terms of the tax incentives provided for research and development activities, and that ranking does not include the benefit of a patent or innovation box that is employed by an increasing number of other countries.

On the international side, the U.S. is the only G–7 country with a worldwide tax system. Twenty-eight of 34 OECD member countries have territorial systems that limit tax to income from activity within their borders.

Countries with territorial systems have adopted a variety of anti-abuse rules to discourage income shifting. Their anti-abuse rules are aimed at preventing the erosion of the domestic tax base, not at preserving a world-wide base. There is no country that imposes a minimum tax on active business income like that proposed by the Obama administration.

A tax system should create a level playing field that does not favor one owner over another, but our worldwide tax system places a premium on the value of U.S. companies' assets in the hands of a foreign bidder. Eliminating the disadvantage U.S. companies face by aligning our rules with the rest of the world would be a far more effective response than building higher walls around an uncompetitive tax system.

The globalized world in which we live increases both the competition American businesses and workers face and the opportunities available to them. If we want to build a sustainably revenue-neutral tax system, then, as Jon Moeller, the CFO of Procter and Gamble, observed last month, we must have a competitive system.

Our international tax rules have fallen behind other countries' efforts to promote economic growth by attracting investment and jobs. It is time for Congress to do the same.

Thank you. I would be pleased to answer any questions.

The CHAIRMAN. Well, thank you very much. We appreciate your comments.

We will go to you, Mr. Smith.

STATEMENT OF ANTHONY SMITH, VICE PRESIDENT OF TAX AND TREASURER, THERMO FISHER SCIENTIFIC, INC., WALTHAM, MA

Mr. SMITH. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, good morning. It is an honor to appear before you. My name is Tony Smith. I am vice president of tax and treasurer of Thermo Fisher Scientific. I am here today to appeal for tax reform, specifically international tax reform. I applaud the committee's interest in building a more competitive U.S. international tax system.

Thermo Fisher manufactures, sells, and services analytical instruments, specialty health diagnostics, and lab products. We supply products wherever scientific research is carried out. The company is headquartered in Massachusetts, with sites in 30 States and employees serving customers in every State. We have 50,000 employees worldwide, with about half the workforce in the U.S.

Our global revenue also is split roughly 50/50 between the U.S. and overseas. Our markets are global, and we sell a lot of our products overseas through U.S. exports and local manufacturing. Thermo Fisher manufactures a substantial volume of products in the United States. We benefit from the reduced tax rate on domestic manufacturing under section 199. The company conducts substantial R&D in the U.S. and benefits from the R&D tax credit when it is available.

We have significant outstanding debt. The proceeds of this debt, along with funds generated from operations, are used to make strategic acquisitions. While approximately half of the company's annual cash flow is generated overseas, we currently have very little cash overseas because the vast majority of the funds are reinvested in the business.

The combined effect of the high U.S. corporate tax rate and the U.S. worldwide tax system limits the flexibility of Thermo Fisher and other U.S. companies to deploy foreign earnings in productive uses in their U.S. businesses. Most U.S. companies, including Thermo Fisher, allow their foreign earnings to remain overseas rather than face a large tax cost to repatriate the funds. If funds are needed in the U.S., we and other companies borrow, rather than access the earnings trapped overseas. Having a tax regime that creates a disincentive for U.S. companies to pay down debt and actually creates the incentive to incur new debt is not good policy.

A tax policy that results in cash being trapped offshore creates an incentive for acquisitions of foreign companies, sometimes leading U.S. companies to over-pay for such acquisitions. The current U.S. tax system also puts U.S. companies at a disadvantage when bidding against a foreign company for both U.S. and foreign companies. As a result, Thermo Fisher has been out-bidden several times in the competition for strategic acquisitions. I firmly believe that a reduced corporate tax rate and more flexibility to repatriate foreign earnings would encourage investment and generate jobs in the U.S.

A corporate tax rate between 25 percent and 30 percent would put the U.S. closer to other developed economies. There will always be significant advantages to being headquartered in the U.S., so it is not necessary for the U.S. to match the world's lowest tax rates.

In addition, we should retain the section 199 manufacturing incentive.

Repatriation of foreign earnings should be allowed at a lower, but not necessarily zero, tax cost. A tax on repatriated earnings in the U.S., at a rate of 5 percent or slightly higher, would not be a significant barrier to bringing funds home because most U.S. companies will value the flexibility to redeploy earnings in the U.S.

Tax reform should include provisions that incentivize research in the U.S. Making the R&D tax credit permanent would encourage the development of intellectual property in the U.S. A targeted reduction of the tax rate on IP earnings would encourage ownership and use of valuable IP in the U.S.

Simplifying the subpart F and foreign tax credit rules would reduce administrative burdens and uncertainties and better target the rules to their intended purposes. However, I also recognize that there must be trade-offs. Consideration could be given to a limit on deductions for interest expense. An appropriately structured limitation would encourage repatriation to pay down debt where the other reforms make such a repatriation feasible.

One-off tax incentives and holidays should be avoided. I view eliminating LIFO inventory accounting and accelerated depreciation as an acceptable trade-off for other reforms that provide permanent benefits.

These priorities would create a more stable and more competitive environment for U.S. companies operating in today's global economy. In my opinion, the goal of international tax reform is not to reduce U.S. tax paid, but rather to reduce the ways in which the U.S. tax system impedes the flexibility and productivity of U.S. companies with global operations.

This committee has already done significant work on tax reform. I urge you to continue the effort to get the international tax reform over the finish line soon.

Thank you for the opportunity to present these perspectives. I am happy to answer any questions.

The CHAIRMAN. Thank you so much.

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

The CHAIRMAN. Dr. Altshuler?

STATEMENT OF ROSANNE ALTSHULER, Ph.D., PROFESSOR OF ECONOMICS AND DEAN OF SOCIAL AND BEHAVIORAL SCIENCES, RUTGERS UNIVERSITY, NEW BRUNSWICK, NJ

Dr. ALTSHULER. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, it is an honor to appear before you today to discuss the very important topic of international tax reform. I believe there is broad agreement among policymakers and companies that our current system for taxing the income earned abroad by U.S. corporations is very complex and induces inefficient behavioral responses.

The system provides incentives to invest in some locations instead of others, to engage in costly strategies to avoid U.S. taxes on foreign dividends, and to shift income from high- to low-tax locations by using inappropriate transfer prices or paying inadequate royalties. Where the tax burden under U.S. rules exceeds what could be achieved through a non-U.S. parent structure, pressure

exists to change the parent corporation's domicile to a foreign jurisdiction. Many are calling for reform and support moving to a territorial tax system.

I recently worked with Steve Shay of Harvard Law School and Eric Toder of the Urban-Brookings Tax Policy Center on a report that explores other countries' experiences with territorial tax systems. We examined the approaches and experiences of four countries: Germany and Australia, both of which have longstanding territorial systems, and the U.K. and Japan, both of which, within the last 6 years, enacted territorial systems by exempting from home country taxation either all or 95 percent of the dividends their resident multinationals receive from their foreign affiliates, what is commonly called a dividend exemption system.

We examined the factors that drove their policy choices and put forward lessons we believe the United States can take away from their experiences. I would like to highlight six conclusions from this work that I believe are important for policymakers as they contemplate reform. I will end by briefly discussing the benefits of a reform that would remove the U.S. tax upon repatriation of foreign profits and impose a minimum tax on foreign income.

The six lessons are as follows. First, the classification of tax systems as worldwide or territorial oversimplifies and does not do justice to the variety of hybrid approaches taken in different countries. All tax systems, including ours, are hybrids that tax some foreign business income at reduced effective rates. As in so much else in taxation, the devil is in the details.

Second, the circumstances that have caused other countries to maintain or introduce territorial systems do not necessarily apply to the United States; therefore, other experiences do not necessarily dictate that the United States should follow the same path.

Third, the tax policies of countries with dividend exemption systems have been greatly influenced by their separate individual circumstances.

Fourth, the burden of the tax due upon repatriation of foreign earnings may be a lot higher in the United States than it was in the United Kingdom and Japan before they adopted dividend exemption systems.

Fifth, the fact that the United States raises relatively little corporate tax revenue as a share of GDP than other countries, while having the highest statutory corporate rate in the OECD, has multiple explanations and does not necessarily suggest that U.S.-based companies in any given industry are more aggressive at income shifting than foreign-based companies.

Sixth and finally, the ability of the U.S. to retain higher corporate tax rates and tougher rules on foreign income is declining. In the last 2 decades, differences between the U.S. and other countries' tax systems have widened. The global tax environment has changed and will continue to do so.

The U.S. need not follow others' tax policies, but our reform process should not be done in a vacuum. It is fundamental to understand the forces that have shaped reforms of our competitors and recognize that, while our economies are different, we do indeed face some of the same pressures.

What should we do? Harry Grubert of the U.S. Treasury and I recently evaluated a variety of reforms and proposed one that makes improvements along a number of behavioral margins that are distorted under the current system. We would start by eliminating the lock-out effect by exempting all foreign earnings sent home via dividends from U.S. tax. This reduces wasteful tax planning and simplifies the system.

Then we would impose a minimum tax of, say, 15 percent on foreign income. As a result, companies would lose some of the tax benefits they enjoy from placing valuable and tangible intellectual property like patents in tax havens and from other methods of income shifting. The minimum tax could be on a per-country basis, but it could also be on an overall basis, which would be much simpler.

As an alternative to an active business test, the tax could effectively exempt the normal profits companies earn on their investments abroad by allowing them to deduct their capital costs. That way the tax would apply only to foreign profits above the normal cost of capital, and companies would not be discouraged from taking advantage of profitable opportunities abroad. Only super-profits or excess profits above the normal return typically generated from intellectual property, which are most easily shifted and would be made in the absence of the tax, would be subject to the minimum tax.

There are other options, but my analysis with Harry Grubert suggests that combining a minimum tax with dividend exemption can make improvements across many dimensions, including the lock-out effect, income shifting, the choice of location, and complexity.

Thank you. I would be happy to answer questions.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Altshuler appears in the appendix.]

The CHAIRMAN. Mr. Shay?

STATEMENT OF STEPHEN E. SHAY, PROFESSOR OF PRACTICE, HARVARD LAW SCHOOL, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. SHAY. Thank you, Mr. Chairman. Chairman Hatch, Ranking Member Wyden, members of the committee, it is an honor to appear before you today. I am testifying at the invitation of the committee, and the views I express are my own and not those of any institution or entity with which I am associated, and in some respects also not my co-author. As you will see, we have some differences in terms of prescriptions.

I recommend that our income tax system have a very broad base and a progressive rate structure that retains public support through apportioning tax burdens according to ability to pay. Rates should be set to provide revenue needed for public goods that support high-wage jobs, innovation, productive investment, income security for those in need, and personal security from domestic and international threats. These public goods include education; basic research; legal, physical, and spectrum infrastructure; income security transfers; and defense. These are what support a high stand-

ard of living for all Americans. One thrust of these observations is that we should design our tax system to raise the revenue that we spend and stop using a tax system as a back-door tool to regulate the size of government and to make non-transparent, de facto public expenditures for specific industries or interest groups.

The taxation of U.S. multinationals' foreign business income is just one part of our overall tax system and should not be viewed as separate and distinct. If we are going to provide a tax advantage for this income, then the revenue saved by those taxpayers will be paid by somebody else.

The evidence is that most U.S. multinationals are not paying high effective rates of tax on foreign earnings. Based on 2006 tax return data, 46 percent of earnings of foreign subsidiaries that reported positive income and some foreign tax, were taxed at foreign effective tax rates of 10 percent or less. These foreign effective rates are not fully explained just by lower foreign corporate tax rates in major U.S. trading partner countries, but reflect ongoing corporate multinational structuring to minimize tax by source and residence countries.

Today, most international tax structures employ intermediary legal entities that do not bear a meaningful corporate tax because they are located in countries that facilitate very low effective tax rates on the income. Aggregate and firm-level financial data evidence substantial U.S. tax base erosion under current law.

My reading of the evidence and my experience is that the U.S. taxes U.S. multinationals' foreign business income too little in too many cases, and not too much. I do not think the evidence supports claims that U.S. multinationals are non-competitive as a result of U.S. international tax rules. This leads me to recommend that the committee consider three areas for reform.

First, improve taxation of foreign business income. My first choice would be to follow the Wyden-Coats approach of taxing foreign earnings on a current basis. If that is not feasible, then I recommend a minimum tax on foreign business income, that is, an advanced payment against full U.S. tax when earnings are distributed from the business. I would not give up the residual U.S. tax on foreign earnings.

Second, I would strengthen the U.S. corporate tax residence rules and the earnings stripping rules in order to reduce the incentives of U.S. companies to move their corporate residence abroad.

Third, I would recommend reducing the U.S. tax advantages for portfolio investment in foreign portfolio stock over U.S. portfolio stock.

So let me just move for a moment to the advanced minimum tax that I have described in my testimony. Under this tax, a U.S. shareholder and controlled foreign corporation would be required to include in income the portion of the CFC's earnings that would bring its residual U.S. tax up to achieve a minimum tax on the foreign earnings. The target minimum effective tax rate would be based on a percentage of the U.S. corporate tax rate so we adapt as U.S. corporate rates change. Deductions by U.S. affiliates allocable to the CFC's earnings only would be allowed to the extent the CFC's earnings were actually or deemed distributed. This is a proposal that fits well within current law.

I am going to skip to my last proposal on portfolio dividends and portfolio holdings, because I think it has been least addressed. Under current U.S. law, a U.S. portfolio stock investor can earn a higher after-tax return on foreign business and earned income earned through a foreign corporation than through a domestic corporation carrying on exactly the same business.

One alternative would be to determine the foreign portfolio shareholder-level U.S. tax in two parts, one part to top up the corporate level tax that is not being paid abroad and then to tax the remaining earnings as under current law.

I would be happy to answer any questions that the committee might have, and I appreciate the opportunity to testify.

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

The CHAIRMAN. Well, thank you. We appreciate all of you being here, and we appreciate your various, respective points of view.

Let me just ask you this, Professor Shay. You wrote in an article that was published in *Tax Notes* just yesterday, if I recall it correctly, that a reduced rate of U.S. tax on $2 trillion or more of untaxed U.S. multinational earnings to pay for highways and infrastructure is, to truly put it politely, not advisable.

Would you please just briefly elaborate? And is it the reduced tax rate that you find objectionable, or that it would not be very long-term in nature, or something else?

Mr. SHAY. A combination of all of the above. The tax on offshore earnings, if we are going to make changes in that, which I have questions about, that should be part of the broader reform. I think everybody has agreed with that.

But the notion that it somehow is acceptable to do that because it is being used for infrastructure on a one-off basis does seem to me to be very bad policy. I think what we should be doing with respect to those needs is, first, we should be looking at tax instruments that might be more effective, including taxes on energy, and then second, that should be ongoing and able to sustain the ongoing needs of the infrastructure investment.

So I do not think that we should have such a low rate on offshore earnings, particularly earnings that are invested in productive investment, even though they are invested outside of the United States. So, I think there are problems with that proposal across a variety of margins.

The CHAIRMAN. Dr. Altshuler, let me turn to you. In your written testimony, you talk a fair amount about the current international rules creating a lock-out effect, whereby U.S. corporations do not want to bring back earnings to the U.S. You think this creates a fair amount of inefficiency, is that correct?

Dr. ALTSHULER. Yes, that is correct.

The CHAIRMAN. All right. Let me just—you can go on and talk if you would like.

Dr. ALTSHULER. No, go right ahead.

The CHAIRMAN. All right. Let me just ask you a follow-up. You propose a 15-percent immediate minimum tax on the earnings of foreign subsidiaries of U.S. parent corporations, together with a dividend exemption. Now, I have worried that a minimum tax as high as 15 percent would increase the pressure to invert from what corporations are experiencing today. Now, do you think that there

would be considerable pressure to invert if there were an immediate minimum tax of 15 percent?

Dr. ALTSHULER. What I talk about in the testimony is a proposal in which only the excess returns or super-normal returns that corporations earn abroad would be subject to that 15-percent tax. So, for corporations that are just earning the normal rate of return, there would not be an increase in the incentive to expatriate. There would not be an increase in inversions, for instance, or foreign acquisitions if the tax is just on the excess returns, which are usually the returns from intellectual property.

Now it is the case, and I agree with you, that there would be pressure to invert and/or expatriate if we had that minimum tax of 15 percent for the firms that have the intellectual property. But the question that you have to ask is whether or not the system itself is less distortionary than the current system, and whether or not a dividend-exemption system with a minimum tax is less distortionary than a dividend-exemption system without a minimum tax. So you have to put the whole package together.

The CHAIRMAN. Mr. Smith, as I know you are aware, there are many different measurements for tax rates. For example, there are book tax rates, cash tax rates, average effective tax rates, and marginal effective tax rates. Now, given these different types of tax rates, what is the tax rate that is most important to you or to your company, and, if you would, tell us why that is the case. If you could also, elaborate on how operating in the global marketplace particularly impacts the tax rate calculation.

Mr. SMITH. Certainly. Thank you for the question. So the most important measure of tax rate to myself, and to a lot of the investment community out there, is what I call the long-term global cash tax rate. So that is different from the accounting tax rate that we see in our reported accounts. That is actually an accrual tax rate, and there is an adjustment to that when you have your reported accounts, because of acquisitions and disposals.

So we think in terms of the cash taxes that we pay globally, and we look on a long-term basis at what the average will be over time. So, think about the cash taxes we paid in 2014. That was about $600 million in cash taxes we paid in 2014. Something between $300 and $400 million of that was in the U.S.

The way the calculation is done in the case of Thermo Fisher—think of about half our income as being in the U.S. and half as being overseas. That is simply because half our revenue is there, half our workforce is there. So the half of the income that is in the U.S. is subject to U.S. taxation. We have the R&D credit, we have the 199 incentive, we have other things.

So the average tax rate from a cash point of view on U.S. earnings is around 30 percent. The other half of income is subject to tax overseas. We have lower tax rates overseas, we have higher R&D incentives, other rulings, U.K. patent box, lower tax rates generally.

So because of all that, the overseas tax rate on the other half of the earnings from a cash point of view is much lower. The average rate of tax for Thermo Fisher, when you add those up from a cash point of view, is somewhere between 15 and 20 percent. That is the average cash rate. So that is how I think, because that is the

amount of cash taxes that we pay. That is an important measure for us. It is also an important measure for investors.

The CHAIRMAN. Well, thank you. My time is up.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Let me start with you, Ms. Olson.

The CHAIRMAN. Could I mention that I have to go to—pardon me, Senator Wyden. I have to go to the Judiciary Committee, and Senator Wyden has kindly offered to make sure this speeds along with the various questions.

Senator WYDEN. Thank you very much, Chairman Hatch. We are going to work in a bipartisan way on this.

Let me start with you, Ms. Olson, because I have always admired that you have been interested in moving on these issues in a bipartisan way and have given good counsel to people on both sides of the aisle. I thought it would be smart, at least for my questions, to start with this issue of base erosion and profit shifting.

I define this as, in effect, tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax locations where there is not much, if any, economic activity, so people do not end up paying many taxes.

What is so troubling and challenging about this is that, with the piecemeal changes, it just seems that clever lawyers and accountants always find their way around it. Now, you have been working on this since your days in the Bush administration, and you were focused on approaches that I thought had some real promise and unfortunately were not picked up on: earnings stripping and others. But take a minute and give the committee some of your counsel on what you think would most effectively stop base erosion and profit shifting at this point.

Ms. OLSON. The thing I would say that could be most effective in stopping base erosion would be reducing the U.S. rate. Clearly a high rate is a disincentive to locate your most profitable activities here in the U.S. It is also an attraction for deductions, for leverage, such as the kinds of earnings stripping that the Bush administration proposal went after back in 2002 to 2004 when I was at the Treasury Department.

So probably the best thing that we could do would be to dramatically lower the U.S. rate. If there is a country that is willing to offer a lower rate than the U.S., particularly on activity that is mobile, like intellectual property and tangible assets, that activity is going to migrate there if it can. European countries in particular that are willing to offer patent and innovation boxes with rates in the 5- to 10-percent range are going to continue to attract that kind of activity.

So, if we are serious about preventing shifting of profits, base erosion out of the U.S., we should bring down the rate. We ought to have an anti-base erosion feature that does look at our own base and that protects our own base, but I think it would make sense for us to define our own base the way that other countries have defined their own base. They are looking at activities within their own borders and trying to make sure that the income generated by those activities within their own borders is not eroded.

So those would be the things I would do.

Senator WYDEN. I very much share your view that a competitive rate is essential as part of this. I just think there are going to need to be some other steps—and you alluded to them at the end—that we need to take in this country to prevent base erosion.

Just in the interest of time, I am going to move on to you, Dr. Altshuler, if I might, with respect to simplifying the tax system. We know that the international tax system is inherently complicated. My question to you is, would not rolling back deferral go a significant way towards corporate tax simplification by eliminating this incredibly byzantine, complicated system that exists to, in effect, track unused foreign tax credits and the related earnings and profits?

I mean, in effect, if you roll it back—and I am using those words deliberately—it would seem that income would either be subject to immediate taxation or be exempt, and the current foreign tax credits would be utilized against current taxable income. So rolling it back, in my view at least, offers an opportunity towards some measure of simplification. What is your take on that?

Dr. ALTSHULER. My take on that is that you are correct, that there would be some measure of simplification if we were to roll back deferral. One thing that we cannot forget when we think about a full inclusion system is that there would still be a situation in which firms have excess credits. I do not think that we will be able to get rid of that. As soon as firms have excess foreign tax credits that they cannot use, you are back in a situation like the current system in which you will be able to use credits to shelter royalties, and you are going to get into all of that tax planning.

So the rate that you end up at is really important, and just taking into account that you do not solve all problems by going that way, that you still have these excess foreign credits to deal with. Once you have those, you have the same incentives that you have under the current system.

Senator WYDEN. A fair point.

Senator Roberts?

Senator ROBERTS. Yes. Thank you, Mr. Chairman. I know the chairman has made a very good statement with which I agree, and I agree with your statement with regards to crashing waves. I might point out that if you have crashing waves, you are going to have base erosion.

I would like to state that Mr. Smith has come to Washington with a very good comprehensive review. Thank you for your extensive investment and employment in Lenexa, KS. We are very proud to have you there. Thank you for your testimony.

I am pleased you are here representing a company with significant operations in Kansas, where we take pride in the growth and development of our life-science and our bio-tech sectors. You are a world leader in innovation in those sectors, and your perspective is important, especially in regards to the general need for predictability, certainly in the tax environment, the lock-out effect of current policy, and the impact of these policies on your ability to grow your company.

There has been a lot of discussion about that lock-out. I am worried about that simply leading to increased taxes. We are not

under-taxed in this country, and that is a concern of mine when we talk about general tax reform.

You call for a reduction in the business tax rate—note I did not say corporate—something which I think is very important to achieve. Given your sensitivity to rates, would you support moving reform of the international tax system on a separate track from the overall business tax reform?

Mr. SMITH. I certainly would, and the reason I say that is because I think that international tax reform can be done on a compartmentalized basis. I think if we bring business tax reform into the mix as well—I think trying to bring in a broader reform makes everything much more complicated.

So I do think we need to try to achieve a focus on international tax reform to achieve a result. I really think we can get that done in a reasonable time frame. If you broaden the scope of reforms, it just takes longer to do.

Senator ROBERTS. I appreciate that. Summing up: let us do what we can do first and get it done.

I know from your testimony that Thermo Fisher is a heavy R&D company. You recommend additional stable incentives for R&D in the utilization of intellectual property in the U.S. Would you support the implementation of a patent box regime in the United States?

Mr. SMITH. I certainly would encourage that. I spent a lot of time, as you can imagine, in the U.K., looking at the U.K. patent box regime. It does work. It does incentivize companies to spend more money and patent more things in the U.K., and so I think we should mirror something like that in the U.S. I do think that would incentivize more research in the U.S. and the generation of more income, and therefore more jobs, in the U.S. So, I think we should do that.

Senator ROBERTS. Mr. Chairman, I want to thank all members of the panel for their testimony. I know we have a whole bunch of votes coming up, so I yield back.

Senator WYDEN. Thank you, Senator Roberts.

Senator Schumer is next.

Senator SCHUMER. Well, thank you. I thank the chairman and Ranking Member Wyden for organizing the hearing.

As you know, Senator Hatch and you, Senator Wyden, have asked Senator Portman and I, along with several other members of the committee—Warner, Carper, Brown, Enzi, Roberts, Cornyn—to find a consensus in the area of international tax reform, and I have to say we are making good progress. I am pretty heartened by how it is going.

So I have a number of questions. I am going to get right to them. First, a little discussion about what is happening around the world, specifically with regard to the OECD—we call it BEPS, for Base Erosion and Profit Shifting. Yes, I know. I hate that word: BEPS project.

I have been talking about international tax reform with a number of U.S. CEOs over the past several weeks. One point that has really stood out to me, one that I do not think we are paying enough attention to on the Hill up here, is the fact that the rest of the world is already acting. We sit around talking in theory

about tax reform; other G–20 governments are proactively enacting new tax policies that are, to put it bluntly, stealing our tax base and forcing our U.S. multinationals to send jobs and assets overseas. It is a game of Hungry, Hungry Hippos. We are sitting on our hands, and other countries are trying to gobble up the field.

As we all know, many European countries already have in place patent box regimes intended to provide a discounted corporate rate on certain intellectual property. Belgium, France, Hungary, Italy, Luxembourg, Netherlands, Portugal, Spain, and the U.K. all have them, and Ireland proposed one.

In the context of BEPS, the idea of "a nexus requirement for patent boxes" is being discussed. I know this sounds technical, but stay with me. What this means is that, in order to receive the benefit of the discounted rate on IP in these countries, the business will have to prove that R&D activity associated with the IP was performed in that country, and that is a good thing in terms of combating the ability of multinationals to stash their IP in low- or no-tax jurisdictions.

It is a wake-up call for all of us who want to keep R&D and associated manufacturing jobs in the U.S. It is actually a very good thing for us if we can move forward. It would really help us. In addition, as Ms. Olson points out in her testimony, a lack of resolution on BEPS is resulting in many countries contemplating unilateral action. So that is the worst thing that we can do as policymakers: sit on the sidelines and watch this happen. That is my view.

So here is the question to all the witnesses: how concerned are you about the impact of either BEPS activity or unilateral tax policy changes in other countries on our domestic corporate tax base? CEOs have told me they think the impact will be felt in months, not years. Would you agree? I want our jobs to be this red, white, and blue, not the E.U.

So, go ahead.

Ms. OLSON. As you mentioned, Senator Schumer, my testimony does address what is happening at the OECD with respect to BEPS. It is something that I think the U.S. Congress should be paying more attention to than it is. The OECD project was intended to address what was viewed as an unraveling global consensus about the allocation of taxing rights, but, as a practical matter, there has been a lot of heated political rhetoric surrounding it, and that has caused a lot of other governments to decide to move forward with unilateral actions that indeed could take part of our tax base.

Even our close ally and strong proponent of the BEPS project, the U.K. government, has announced a diverted profits tax that is even nicknamed after a U.S. company, and that is slated to take effect on April 1st. So other governments clearly are moving, and it really is important for the U.S. to pay attention to this, to follow what is going on at the OECD, and take unilateral actions.

Senator SCHUMER. Mr. Smith?

Mr. SMITH. Certainly I view BEPS as being an attempt by overseas jurisdictions to put forth legislation which drives income and jobs back into their jurisdictions and then encourages those jobs to stay there through other means, be it R&D or patent boxes, or

something like that. So it is driven to reduce base erosion, but it is also driven to incentivize growth of jobs in overseas jurisdictions. We need to compete with that, so we need to keep up with those changes.

Senator SCHUMER. Does anyone else have anything to add? Dr. Altshuler, Mr. Shay?

Dr. ALTSHULER. I think what is going on just shows again, and forcefully, that we need to be looking at our international tax system, and we need to be looking at our corporate tax rate.

Senator SCHUMER. Mr. Shay?

Mr. SHAY. I will be the dissenter here, I think. I come from Cambridge, MA. Within 4 miles of my house are the greatest research institutions in the world. Patent boxes did not create those institutions. Solid education did, and funding for people who end up in those institutions.

I am worried that we are being distracted by noise and we are not paying attention to the fundamentals. The fundamentals are, we should design a broad-based tax. The notion that we can use the tax system and target this and target that—I spent decades as a tax planner. Every time you create an exception or a rule, if I can use it, I will use it.

I have written an extensive article on an earlier version of the Camp report. In that article I demonstrated different ways we would end-run those rules. I encourage you to step back, keep the big picture in mind: broad base, lower rates. Certainly a lower corporate rate would help, but it is very difficult to pay for. If we are being realistic, we are not going to drive it down to the levels that people are talking about.

Senator SCHUMER. Correct.

Mr. SHAY. So we are going to need anti-base erosion proposals ourselves. They are in my testimony. We need to strengthen our definition of corporate residence. We need to strengthen our earnings stripping rules. There is no magic pill, and a patent box is absolutely not a magic pill.

Senator SCHUMER. So just to clarify—and I will be quick; my time is up—if we could not get the rate down low enough to make a real difference, you still would not enact a patent box?

Mr. SHAY. I think a patent box is terrible policy.

Senator SCHUMER. All right. Thank you.

Mr. SHAY. But everything is in the details.

Senator SCHUMER. Thank you.

Senator WYDEN. Thank you, Senator Schumer. It sounds very encouraging that Senator Schumer and Senator Portman are making some real headway.

Colleagues, we have a vote already on. I think we can get Senator Stabenow in before the vote. The question is whether we will have one or two votes, but we are going to just try to keep moving.

So, Senator Stabenow?

Senator STABENOW. Thank you very much, Mr. Chairman, for this hearing, for you and Senator Hatch providing this hearing.

Let me ask, Mr. Shay, as a follow-up, talking about policy options as they relate to tax policy on jobs going overseas. I have had legislation for some time that is pretty simple, the Bring Jobs Home Act, that just would stop companies from being able to de-

duct their moving costs, their costs incurred when they physically move overseas.

I do not think the taxpayers or workers whom they leave behind should be subsidizing that. We have talked a lot about inversions and earnings stripping and so on, but we should also look at the fact that companies are able to gain other tax benefits from offshoring American jobs using a foreign subsidiary, making something, bringing it back to the United States and so on, selling it here while they are competing with companies that are staying here in America.

I wonder if you might speak more about this particular problem, and policy options as we go forward, making sure that we are in fact supporting American businesses that are choosing to be here in America and invest in America.

Mr. SHAY. Well, one general observation that I have made in my testimony is, if we provide more favorable taxation for foreign earnings, then it ends up affecting the rest of the system. So, if we want to encourage operating in the United States, one way—from a policy point of view I think a preferred way—is to try to make the taxation of income as equal as possible.

We cannot control what other countries do, but, as I have suggested in my testimony, either we take the approach that is described in the Wyden-Coats proposal of trying to broaden the base and bring down rates but then tax foreign earnings currently, or, if we are not going to get that far and it is a daunting task, I have proposed an advanced minimum tax that would take away basically the benefits of putting operations or trying to shift income into tax havens in low-tax countries.

I think those are approaches, combined with anti-abuse rules, that are practical and that we are going to end up needing under any plausible scenario where we come out in this process.

Senator STABENOW. Thank you.

Mr. Smith, your company does a lot of manufacturing, including in Kalamazoo, MI. We are happy to have you. If there is time, I would certainly welcome anyone else on the panel to respond as well. But as you know, or at least as I would say, we do not have a middle class unless somebody makes something.

A quarter of working people worked in manufacturing in the 1970s; now it is about one out of 10. So, lots of challenges on the one hand: productivity is up. I mean, there are lots of reasons for that, but it is still very important that we manufacture in this country.

So what are some of the key components of tax reform that in your mind would support and promote American manufacturing and new investments in the United States as opposed to those investments going overseas?

Mr. SMITH. That is a great question. Thank you for that. So, if you look at Thermo Fisher, in Thermo Fisher's case, about half of our earnings are overseas. That is just the way we do business.

So if we had an incentive, or at least not a disincentive, to bring our earnings from overseas back to the U.S. and then reinvest them in the U.S., then we could reinvest them in the U.S. because we have a lower tax rate and maybe a patent box or some lower

tax rate from generating income from those jobs in manufacturing higher-tech, higher-IP products.

That would certainly grow jobs in the U.S. So the lock-out effect to me, whereby offshore earnings are basically stuck offshore, if we end that and we bring the earnings back to the U.S., we will reinvest them in the U.S., and then we will grow jobs. I think if you combine that with a lower tax rate, the job growth would be pretty substantial.

Senator STABENOW. When we look at things like the R&D tax credit—and about 70 percent of that is auto companies, manufacturing using the R&D tax credit—or we look at accelerated depreciation on equipment purchased here and so on, in your mind are those things important for us to maintain as part of encouraging investments here and R&D here?

Mr. SMITH. So the R&D credit is an important credit. I do think a lower tax rate on income generated from intellectual property, whatever that might be, is very important. I think that tax incentives, which I consider to be one-off cash-based incentives like accelerated depreciation, I think because they are one-off in nature, I am not in favor of those. Those are things that I certainly think we should consider giving up if we can get the other things I talked about.

Senator STABENOW. Interesting. There are varying views on that. I certainly hear the other side of that.

Well, I think my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Scott?

Senator SCOTT. Thank you, Mr. Chairman. I think there is an opportunity for both myself and Senator Portman to be heard before we have to leave for our vote, so I am going to just ask one quick question of Mr. Smith. Of course, you have come to Washington, as Mr. Roberts has suggested, so you obviously have all the information that I will need on my question on how the fact of the complexity and the higher rates and the worldwide reach of our current tax code is really causing our tax inversions.

No matter how many corporations invert, there are a couple of things that I believe are inherent within the American psyche and our competitive position—our education and workforce—and particularly in South Glen where we have seen foreign investment create more than 116,000 jobs. And over 65,000 of those jobs are in manufacturing.

I think it speaks to the strength of our education system, our strong workforce, our desire to be competitive globally. Companies like Michelin have 8,900 jobs in the State; Daimler just announced a $500-million expansion, adding 1,200 additional employees in South Carolina.

The challenge is that inversions are a natural result of an unnatural tax code, bottom line. So, as we look at many options to eliminate tax inversions without dealing with the fact that we need a lower tax rate, I am worried that our proposals might have the effect of discouraging foreign direct investment, which has brought millions of jobs to our shores, obviously over 100,000 in South Carolina.

Mr. Smith, do you have any thoughts on this based on your experience in a multinational corporation?

Mr. SMITH. So, when I look at inversions, some of the jobs that may move when companies invert are really in terms of the head-office function. So, when you have a U.S. company that becomes headquartered overseas, then head-office functions do go overseas.

I do not actually see a lot of change in the manufacturing jobs in the U.S. I think it is those higher-level head-office jobs which do move. They are still jobs. They are highly paid jobs. We certainly should not be incentivizing moving those overseas. But I think manufacturing jobs—I do not think they change very much because of inversions or lack of inversions. I think that is a fairly stable situation.

Senator SCOTT. Thank you.

I will yield the rest of my time, with the chairman's permission, to Senator Portman.

The CHAIRMAN. Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman, and thanks to my colleague from South Carolina for yielding.

First of all, I really appreciate you all being here, and I wish we had all day to talk about this. So many questions! Senator Schumer mentioned that we are heading up this international working group together, and we have had some good success in identifying the problem, and now we are moving toward solutions. I think there is a good deal of consensus here. We have heard a lot of consensus from the table here, including a lower rate.

I guess what I would like to focus on is three things, quickly. One is, although inversions are reduced thanks to the regulations and threat of more, what we are seeing is more foreign takeovers. I would ask unanimous consent to enter into the record the *Financial Times* story from yesterday which says, "Crackdown on tax inversions allowed U.S. companies to slash their tax bills and had the perverse effect of prompting a sharp increase in foreign takeovers."

[The article appears in the appendix on p. 56.]

Senator PORTMAN. This is also consistent with what we are seeing generally. The *Wall Street Journal* ran a story, and recently the Ernst and Young report, which some of you have seen, talks about what is happening, and what has happened over the last—not just recently, not just because of these regulations.

The Salix acquisition is probably the best case in point recently where they did not invert because of the rules and then they were bought by a foreign company that had inverted. Of 12 suitors, I am told 11 were foreign companies. The twelfth is in the process of inverting. So this notion that we are not losing companies and headquarters and so on—it is happening.

The second one, though, goes to your ability to expand as a U.S. company. Everybody here has great expertise in this, but, Mr. Smith, since you are representing the company here today—and thanks for what you do in Ohio. I loved visiting your plant last year. Talk about that for a second.

I think it is one thing we are missing in this debate. I think we understand what is going on. We have more foreign transactions, more U.S. companies being taken over, and that will continue to happen. I am a beer drinker. Try to find a U.S. beer. The biggest one is Sam Adams, with a 1.4-percent market share.

But in terms of this notion of being able to grow as a U.S. company, when you are competing overseas, particularly for an acquisition—and by the way, there are all sorts of new data on what that means for U.S. jobs. To acquire a U.S. company, an overseas entity adds jobs right here. But what are you competing with?

Mr. SMITH. So we are competing in two different situations. The U.S. multinational population, a lot of those companies do have earnings and cash overseas. So, when a foreign target is actionable and when a foreign company could be purchasable, there are lots of bidders for that, and so the price goes up.

So we do see situations where people who have a substantial amount of cash overseas will bid the price up for a foreign target simply because there is no other productive use for it. That is just not good policy. We should not be doing that. That is incentivizing increasing purchase prices.

The other situation is, we cannot get, in the U.S., to all our global earnings because half are locked out, in the case of Thermo Fisher. So when we compete for purchasing other U.S. companies or other foreign companies, whatever it might be, only half our earnings are available to us because the other half are locked out. That puts us at a substantial disadvantage.

If we were able to make those acquisitions, I do think jobs would grow in the U.S. because of it. But because of the way that our cash builds up overseas because of our structure, because of those offshore earnings that we have through operations, we cannot do it. We cannot compete.

Senator PORTMAN. I have a story. Recently an Ohio company wanted to expand and purchase a subsidiary in Korea where they do business, the Republic of Korea. After they were done with the negotiations, a European company stepped forward and said they would pay 18 percent more of whatever was negotiated because their after-tax profit is greater because of their tax system. Their point to me was, we cannot expand. We are handicapped. You are nodding your head.

So the final question that I have has to do with BEPS again and this notion of the patent box and what we ought to do. The administration, I think, has a lot of common ground with this committee in terms of addressing this issue, but one issue that troubles me a little in terms of what the Europeans are doing is to put a minimum tax in place.

If you had a 19-percent minimum tax, as the administration has proposed, it does not provide the incentive to locate IP here. It may create some disincentives for companies to go overseas with the IP because there is a 19-percent minimum rate, but, particularly with the direction the E.U. is going with its nexus requirement, it seems to me IP located overseas is going to necessarily bring more R&D with it. So maybe, Ms. Olson, since you have done a lot of work in this area, you could comment on that.

But given where the world is, not where we might wish it to be, but given how it has changed since the 1960s when we last reformed our international tax system in any substantial way, and given the specific issue of what is going on with patent boxes, what would the impact be of this minimum tax rate in terms of where R&D would occur?

Ms. OLSON. Well, I do not think it would bring R&D back to the U.S. I think it would be a disincentive to relocate, as you have indicated. But as good as our researchers are, including the ones in Cambridge, I do not think any of us have learned how to make water flow uphill.

So if other countries are offering a 5-percent rate or a 10-percent rate and our companies cannot access that, but other companies can, then the result is going to be that other companies are going to get those opportunities and our companies are not. So it is definitely going to disadvantage us.

I think it is important for us to recognize, as Mr. Smith has indicated, that U.S. companies are serving a global marketplace. This is not just about what happens here in the U.S., it is about what happens around the world and the fact that, as you indicated, we benefit. We create more jobs here in the U.S. when we do a better job of serving those markets outside the U.S.

Senator PORTMAN. Thank you all. I am literally going to run to the vote.

Thank you, Mr. Chairman.

The CHAIRMAN. Ms. Olson, let me ask you a question. You were clear in your testimony that the corporate tax rate needs to be reduced significantly. I would like you to elaborate on your point that a reduction in the corporate tax rate would, by itself, reduce the amount of intellectual property migration.

Also, you stated the recent economic study suggests that a significant portion of the corporate income tax is ultimately paid for by labor, not just by the shareholders of the corporations. Could you elaborate on that as well?

Finally and specifically, does this suggest that a cut in the corporate income tax rate is actually, at least in part, a cut in tax for the American worker?

Ms. OLSON. Starting with the last part of the question relating to the corporate tax and who bears the burden, there has been some very good work done by the Congressional Budget Office, the Joint Committee on Taxation, and the U.S. Treasury Department, along with a lot of private researchers, who have concluded that some substantial part of the corporate tax burden—while the checks are written by the corporations—is actually borne by U.S. workers because of the mobility of capital and so forth in the global economy.

The estimates are 20 to 70 percent. There are some who suggest an even higher rate. But it is clear that, in the global economy today, a substantial part of the burden of the corporate tax is in fact borne by workers in the form of lower wages.

So, if we were to reduce the corporate tax, then part of the benefit of that would be distributed, I think, according to the revenue estimators of the Joint Committee, to the individuals who are employed. So it would show up as a reduction in the tax burden borne by the employees and not just the shareholders of the company.

Reducing our corporate rate, I think, is a very important thing to do. Our country is a wonderful country, a wonderful market, with wonderful research institutions, wonderful governance structures. It is a wonderful place to be, but there is only so much of an additional burden that U.S. companies can carry against the

rest of the world. We are so far out of line right now with the rest of the world on corporate tax rates that I think we have to bring our rates down.

In thinking about rates, we need to look at the Federal burden, but we also need to look at the burden imposed by State and local governments, which is why, when we look at the all-in burden, we are looking at 39.1 percent on corporate income. That, of course, does not count the additional tax that is paid by shareholders on dividends and corporate capital gains.

When you put that all together, we have something north of a 50-percent tax burden on corporate income here in the United States, and that is way out of line with where other countries are.

The CHAIRMAN. You write in your testimony that many other OECD countries are developing various patent box regimes or intellectual property box regimes. You discuss extensively how capital is increasingly mobile. This, I would say, suggests a need to change the tax laws.

So my question is this: is the main reason for a patent box to encourage research and development, and, if so, could not the R&D tax credit simply be increased to be a more generous provision? Or is the main reason for a patent box a recognition that any attempt to tax intellectual property at anything more than a very low rate will only result in chasing intellectual property away?

Ms. OLSON. My view is that our R&D credit has served more the purpose of getting companies to locate their R&D activities here in the U.S. than it has actually incented R&D activity to occur that would not otherwise have occurred.

I think the most important point at this time is location. Other countries have R&D incentives at the front end, when you are actually undertaking the research and development activity, and then on the back end as well with a lower rate on the returns to the results of those efforts.

So other countries are going after it on both sides. We could provide a far more generous R&D credit than we currently have to incentivize performing the activities here, but there is probably some benefit in looking at the patent box end as well where we would have a reduced rate on the returns from the endeavors.

The CHAIRMAN. All right.

Mr. Smith, you provide several suggestions for international tax reform in your remarks. One of those suggestions is to "incentivize the utilization of intellectual property in the United States and generation of income here by reduction in the rate of tax on earnings from that activity."

Now, this is generally referred to as a patent box or innovation box regime. Do you have any recommendations for us on how a system might be designed, and, more specifically, how might we address the concerns that some have raised regarding the complexity and game-playing that would occur in the determination of the income attributable to intellectual property?

Mr. SMITH. My greatest experience on R&D credits and patent boxes working well is in the U.K., so I think what we need to do is incentivize expenditure on R&D in the U.S., because that generates very high-level jobs. Mr. Shay mentions the best scientists—a lot of the best scientists—are here in the U.S.

So, we need that credit. We then need a patent box, because then we need to utilize the intellectual property we just developed from the research. What we would need to do is find a way to define what the intellectual property might be, and that could be, do you patent it, is it registered, whatever it might be. There are ways to define what the intellectual property might be.

Then there will be ways to identify what the earnings might be from that. So, if you go to the Netherlands, what is the royalty stream coming from that trademark? That is not a good system, in my view. What you need to encourage is manufacturing the product that is subject to the IP. That creates jobs. That is the income stream that should be subject to a lower rate of tax. I do think it should be fairly easy to identify the intellectual property and what U.S. companies made in terms of earnings from that property.

The CHAIRMAN. All right.

Senator Wyden?

Senator WYDEN. Thank you. Thank you, Mr. Chairman.

I want to ask one question with respect to the territorial issue, because this is going to be an important part of the debate. First, so we are clear on the definition—because I think there has been a lot of debate about what territorial is all about—my understanding is, under a territorial system, a company would pay tax on the earnings in their home country and pay no tax on earnings outside of the home country. Is that correct? Does anybody disagree with that?

Dr. ALTSHULER. I disagree. Go ahead, Stephen.

Mr. SHAY. Go ahead.

Dr. ALTSHULER. It is not all foreign. Territorial taxation does not relieve the U.S. tax burden on all foreign-source income abroad.

Senator WYDEN. Right. I understand.

Dr. ALTSHULER. All right.

Senator WYDEN. All right.

Dr. ALTSHULER. It is on active income abroad.

Senator WYDEN. Correct. Fair enough. Good.

Mr. SHAY. And there is a second point, which is, the proposals differ as to whether or not they provide exemption to foreign branches as opposed to subsidiaries. Some are only for income from subsidiaries, others, such as the administration proposal, cover both. That is a very significant design difference. So, that is to respond to your question.

Senator WYDEN. That point really relates to the question I wanted to get at, because what has concerned me most about the debate about territorial, and I know in this kind of decade-long odyssey that I have been part of with Senator Gregg, Senator Coats, Senator Begich, what always struck me is that going to a pure territorial system does not eliminate the use of game-playing and tax havens and the like, which I think is where Dr. Altshuler was going with her reaction to my first comment. And your writings addressed that too, Mr. Shay. Is that right? We can get the whole panel involved in it.

But it just seems to me that the debate about territorial will be a fierce one, and it has been ever thus. But the idea that it will eliminate tax havens strikes me as an important issue as well, and I do not see how it eliminates tax havens. So, for any of you—Mr.

Shay, you have written on this. We can get all four of you involved in this.

Mr. SHAY. Well, if I may start, I do not think there is a proposal out there today in the U.S. that would provide exemption without also having some form of minimum tax to prevent use of tax havens. It is that exact same phenomenon.

All of the proposals—Camp, Baucus, administration—would be stronger than many of our peer countries. Yet without them, we are going to lose a lot of revenue, which is why, coming back to an earlier question, it is not enough just to focus on that one piece. We are going to still need anti-inversion, anti-base erosion provisions.

But even if you have a minimum tax, there is a real difficulty in designing it so it cannot be gamed. You are correct. I published an article which went through ways to game at least that version of the Camp proposal. You give me any proposal where there is a significant rate difference, and I will find a way to push more income into it than is expected, which does also bring up the patent box.

The U.K. patent box, as I understand it—and Tony can correct me—is drafting a way that you deem a return to certain assets, and the excess above that return is treated as intangible income. That is a very broad, low rate. It is not well-targeted, and it is very hard to target. It is very hard to design that.

Senator WYDEN. Let us, for purposes of discussion—Ms. Olson, is there anything Mr. Shay just said on that point that you would take exception with?

Ms. OLSON. Well, I might. I do not think that we can move to a pure territorial system. I do not think anybody wants to move to a pure territorial system. We have to protect our tax base so that smart advisors do not take advantage of the opportunity to erode the base.

I think the real question is whether we focus on our own base and making sure that we capture all of the income that is attributable to our own base, or whether we decide we want to try to trace the income around the rest of the world.

Professor Altshuler's recommendation of a minimum tax is much simpler administratively. If it does not put us too far out of line with what companies in other countries are allowed to do, then it would also have the benefit of keeping activities here. If it is too broad, then it will not matter how much more administrable it is because we are going to have fewer companies to apply it to. So those are the things that we need to look at, and that is what I think we need to focus on: how do we design a system that encourages activity here in the U.S. and that safeguards our own base?

Senator WYDEN. Thank you.

Let me just apologize to all of you. We have votes, and Chairman Hatch has been very gracious. I think we have to race off to get another vote. But I look forward to working closely with all four of you. You have been very, very constructive and very good.

Thank you, Mr. Chairman.

The CHAIRMAN. I understand Senator Menendez has some questions, so we will keep this open for him. But let me just ask a ques-

tion until he gets here. This is for you, Mr. Shay, but I also invite Mr. Smith to answer this question after Mr. Shay.

Mr. Shay, in your *Tax Notes* article published just yesterday, you wrote, "A material portion of U.S. global business untaxed earnings are invested in active foreign business assets. Presumably, managements do not seek to repatriate earnings invested in active business assets until the assets are sold or disposed of. It is difficult to argue that lock-out is a problem in relation to these earnings while they are so invested."

But could it be the case that at least some of those earnings are invested in active foreign business assets because of the lock-out effect? That is, but for the lock-out effect, the earnings would instead be invested in active U.S. business assets. Is that possible?

Mr. SHAY. It certainly is possible. There almost certainly is some linkage there. Tony alluded to that in his testimony, but I was relieved to read that Thermo Fisher does not make bad investments. But some other companies might.

It is actually buried in a footnote in my article. As I point out in the article, the real question is, is the extent of sub-optimal investment in real assets in the foreign subsidiaries greater than the extent of sub-optimal investment domestically? The reason I ask that is, I have been involved in, or had as clients, companies that have made absolutely terrible acquisitions in the United States. What happens when you get into a deal is, deal fever can take over, and you can pay a bad price. It happens over and over again.

The question is, how much does lock-out contribute to that in connection with foreign assets, and how great is the differential from just what happens normally? I am not persuaded—and particularly given the very high levels of cash holdings, there is not a lot of evidence to me that the amount of bad deals is disproportionate, which it would have to be in order to ascribe to lock-out, the effect that we are talking about.

I worry much more about unused cash sitting offshore. Frankly, as I argue in the article, I think a lot of that is invested in the U.S. economy, so I do not think it is as big a problem. But if I am an investor in a company, I start to worry about it.

The CHAIRMAN. Mr. Smith, do you care to comment?

Mr. SMITH. So, from a treasury perspective, the treasury within Thermo Fisher, I would love to be in a situation where all of our global cash is available to us in the U.S., and right now it is not, because we generate, as I said, about half of our cash overseas through earnings, and it stays there, so it is locked out.

If I am able to get to all that cash in the U.S. with a minimum tax cost, then I have a broad array of choices where I can invest. So I can still invest in overseas assets if I want to, or I can invest in U.S. assets too. So the choice, to me, is much, much broader. That means the competition for foreign assets goes down and we can compete better for U.S. assets because we just have a bigger cash pool, if you would like, back in the U.S.

So I think the lock-out effect really does limit our ability to deploy our funds globally, and that is what I really want to do.

The CHAIRMAN. Thank you.

Let me direct one other question to you, Dr. Altshuler. You discussed the idea of there being an implicit cost in deferring foreign

income. You say that the implicit cost of the repatriation tax in our current worldwide-with-deferral regime is 5 to 7 percentage points today.

Would you elaborate on this a little bit more, please, so that we can understand it maybe a little bit better here in the committee? What do you mean by "implicit cost"? Is this mostly just a deadweight loss in the economy? Who is bearing the brunt of such a deadweight loss, if that is what it is?

Dr. ALTSHULER. Well, it is a deadweight loss. One way to think about it is how much companies would be willing to pay to avoid the tax. So that is a good way to think about it, a way that I would use to explain it to my classes. How much would you be willing to pay to not be subject to this tax in the future? The implicit cost is an estimate that Harry Grubert of the U.S. Treasury and I came up with using data from tax returns of U.S. companies.

The implicit cost is generated by having to undertake inefficient behavior to access the funds that you want to use abroad, so borrowing against the assets that you hold abroad. The more you hold abroad, the more you borrow against assets held abroad, the costlier it is for you to raise funds to invest in the United States. So it really is a cost. It is the cost that the tax system imposes on a company by not allowing them to bring the money back. It is imposed and it is borne by the company itself.

The CHAIRMAN. All right. Thank you.

Senator Menendez, you are the last one. I am going to have to go vote. Let me see. I cannot tell who was first.

Senator MENENDEZ. Mr. Chairman, I am not going to ask for unanimous consent for anything in your absence. [Laughter.]

The CHAIRMAN. I am glad to hear that. Senator Thune would be first, and then you would be second.

Senator MENENDEZ. All right.

The CHAIRMAN. But I am going to have to leave. I have to go to Judiciary. So, if you will shut it down, I would appreciate it.

Senator THUNE [presiding]. Well, thank you, Mr. Chairman.

Thanks to our panel today for your excellent testimony. With everybody bouncing around between different things going on today, I am glad I got a chance to get back and ask a couple of questions.

Anybody can answer this, but over the past few years we have seen a number of proposals to overhaul—and I am sure you have covered a lot of this—international tax rules, from Wyden-Coats, to Senator Enzi's proposal, to the proposal by former Chairman Camp. Given that each of you is an expert in this area, I would be curious to know which of the recent proposals you believe would be the best reform of our international tax system, and why. Feel free.

Ms. OLSON. Of the proposals, I think the one that comes closest would be Chairman Camp's proposal. But I would make some modifications on the international side with respect to the minimum tax, because I think it is too broadly applied. So I think the base on which the tax is imposed should be narrowed, more focused on protecting the U.S. base as opposed to circling the globe.

Senator THUNE. All right. What do you think about the rate?

Ms. OLSON. The rate is on the high side.

Senator THUNE. All right.

Ms. OLSON. I think a lot of these things end up being the result of what the revenue estimators tell the drafters they have to go with, so something that was lower, 10 percent, something on that order, would be more effective.

Senator THUNE. All right.

Mr. Smith?

Mr. SMITH. So I think, again, Chairman Camp's proposals are mostly in line with what I am recommending, although I would make some changes. I do think repatriation should be taxed in the U.S. when the cash actually comes back to the U.S., so I do not think there should be any tax imposed whilst the earnings are offshore.

That also goes to, I guess, the minimum tax or the overseas income tax. My preference would be to only have the income taxed in the U.S. when the cash actually comes back, but otherwise I think we are fairly close on it.

Senator THUNE. All right.

Dr. ALTSHULER. So, I like the idea of a dividend-exemption system, getting rid of that repatriation tax and combining it with a minimum tax. I think the administration rates are too high, the 14 percent on the earnings held abroad and the 19-percent minimum tax. I would go with a minimum tax of 15 percent. This all has to be combined, of course, with the lower corporate tax.

Senator THUNE. Right. All right.

Mr. Shay?

Mr. SHAY. As I say in my testimony, my first choice would be the Wyden-Coats approach with respect to the international provisions, but it does presume a fairly low rate. If that is not going to be achieved—and realistically then you would not get agreement to tax foreign income currently—then I prefer some form of minimum tax. Of the ones that are out there, I do think the administration's is the best. I think it has some problems, like I have suggested, and that is why I have suggested an alternative in my testimony.

Senator THUNE. All right.

It is a reality that we have fewer and fewer of these Fortune 500 companies that are based in the U.S., and they continue to be acquired by a lot of their foreign competitors. How much of that do you think is due to America being one of the few developed countries in the world with a worldwide system of taxation and the highest statutory tax rate? Put another way, are foreign acquisitions driven primarily by business considerations, or do tax considerations play a major role in that? To anyone on the panel.

Ms. OLSON. My view is that there is a lot of activity that occurs because the U.S. is a very attractive market, so foreign companies want to invest here. Foreign companies are happy to acquire U.S. companies.

I do think that if you have, for example, a merger of two similarly sized companies, one being foreign and one being U.S., that when it comes time to decide where the company should be domiciled or headquartered for tax purposes, the answer today is not likely to be the U.S. because of our very high corporate rate. So I think that lowering our corporate rate would go a long way towards having the decision made to have the U.S. be the headquarters in those kinds of situations.

Senator THUNE. All right.

Mr. SMITH. So, in my view, the acquisition by foreign corporations of U.S. corporations, a lot of that is driven by business, because we have great corporations in the U.S. But I think it is inevitable that there is a tax element to that decision, so tax savings definitely would weigh into that, in my opinion.

Senator THUNE. All right.

Dr. ALTSHULER. I agree with what has been said before. I think we cannot ignore that taxes are playing a role here, a major role—that is an open question—but a role that we need to focus in on.

Mr. SHAY. As I think Tony's testimony indicated, you are facing a series of trade-offs. I would not be distracted too much by looking at acquisitions that are within one quarter or two quarters, I would look over a longer period. I think, while tax is without doubt a factor and was a very big factor in inversions, that part of it, I think, has been, at least for the interim, addressed.

I agree with the sentiment, I think, of the other panelists. I would guess by far the predominant portion of acquisitions is driven by business and not tax, on the scale we are talking about. There is just too much risk to be doing something primarily for a tax reason. The inversions were the exception, and that is why it was appropriate to take actions to stop them.

Senator THUNE. All right. Very quickly, because my time has expired, is earnings stripping contributing to corporate inversions?

Mr. SHAY. Yes. Absolutely.

Senator THUNE. All right. Agreed?

Dr. ALTSHULER. Yes.

Senator THUNE. All right. Thank you all very much. I will yield to the Senator from New Jersey.

Senator MENENDEZ. Thank you, Mr. Chairman. Welcome all. Thank you for your testimony. I want to particularly welcome Dr. Altshuler, who is from a great New Jersey institution, being professor and dean at Rutgers University.

A lot of the discussion today has been focused on how uncompetitive the corporate tax rate is, and critics correctly argue that our 35-percent statutory rate is the highest of all OECD countries. But I think we neglect to mention that our effective tax rate is actually right in the middle of that curve. According to the Congressional Research Service, the effective U.S. corporate rate in 2011 was 27.1 percent, slightly lower than the OECD average of 27.7 percent.

Now, having said that, I do see myself supporting a tax reform package that seeks to reduce the corporate rate, but also, while I think that that is important, I do not know that it is the Holy Grail of tax reform. I am concerned about the gap between the United States and the rest of the world, about reducing the infrastructure and education gaps that we have.

We were long the envy of the world in infrastructure, and we now rank just 12th globally, with billions of dollars of maintenance backlogs for roads, rails, and ports. American high school students ranked a dismal 26th out of 34 OECD countries in math.

So, Professor Shay, let me start with you. It is estimated that for every point we reduce the corporate rate, we lose $100 billion in money to the Treasury. How do we look at this in the context of the desire to lower corporate rates, but the necessity, I think, of in-

frastructure investment, both in infrastructure broadly defined and in educational pursuits?

Mr. SHAY. Well, a key question that is at the heart of this hearing is, how do you think about the taxation of cross-border income in that regard? My view is, it should not be left off the table if you are going to try to expand your base.

Expanding the tax base by having tax at least up to some number, at least a minimum tax on income that is earned at very, very low foreign rates and very likely as a result of tax planning and incentives to achieve that, I think that would help contribute to the $100-billion point that you are referring to. In other words, I do not think we should be excluding international income from the base in achieving a lower rate.

At that point, there are quite a few corporate tax expenditures, and they are just going to be very clear decisions. My preference is, as I say in the testimony, a much broader base. Take away as many expenditures as is feasible and either invest that in the rate or invest it in infrastructure or other things that would be valuable for the country.

Senator MENENDEZ. Can we agree that a critical infrastructure and educational excellence in a globally challenged economy are incredible elements as well to future prosperity?

Mr. SHAY. You certainly have my agreement on that.

Senator MENENDEZ. All right.

Let me ask this, Ms. Olson. We have been working on something that has broad bipartisan support in Congress, which is reforming the Foreign Investment in Real Estate Property Act, or FIRPTA, which is basically a punitive tax that acts as a roadblock to investments in the U.S. at a time when it seems to me we should be doing the opposite and incentivizing investment.

Does it make any sense to create obstacles like FIRPTA for foreign investments in the U.S., particularly considering our needs, for example, in infrastructure and a still-looming commercial debt that is out there that has to be refinanced?

Ms. OLSON. Can I give a one-word answer?

Senator MENENDEZ. Sure.

Ms. OLSON. No. It does not.

Senator MENENDEZ. All right.

Ms. OLSON. Clearly, FIRPTA does distort investment decisions about which sector of the economy to invest in, as well as whether to invest here in the U.S. or to invest in another country that does not have that kind of a tax.

Senator MENENDEZ. I hope we can take your “no” and convert it into a powerful “yes” here to reform it. The other day, we started some of that.

Finally, let me ask about inversions. I find this particular activity absolutely reprehensible and un-American, companies that benefit from our intellectual property laws, the protection of our military power and diplomatic expertise, the benefits afforded American businesses in operating abroad, the benefits of our universities and graduate schools, our highways, our infrastructure, the right to claim First Amendment rights in elections, then walk away from the table when the bill comes due. It is almost parasitic, in my mind.

So, Professor Shay, do you believe that a lower tax rate and a territorial tax system alone can end the problem of inversions in the U.S., or will we continue to have a need to address inversions directly?

Mr. SHAY. I do not think that would end inversions alone, because a territorial system, as we have said, would almost certainly be accompanied by other provisions that would need to protect the U.S. tax base. There is still going to be pressure to try to move to some country that just taxes less, so there is going to need to be a whole series of provisions.

But most importantly, we need to re-think our concept of corporate residence. In my testimony, I suggest that we should be taking account of shareholder composition. When the companies are trading on U.S. exchanges, if they have substantial U.S. shareholdings, we should—and it will take a fair amount of designing and thinking to make this a clear proposal—move towards making those companies U.S. tax residents.

Senator MENENDEZ. Thank you, Mr. Chairman.

Senator THUNE. Thank you, Senator Menendez.

Does the Senator from Delaware desire to ask questions?

Senator CARPER. He does. Thanks.

Hi, everyone. Nice to see you. Thanks for joining us and for sharing your wisdom with us.

In the last Congress, I chaired a committee and helped lead a committee with a Republican from Oklahoma named Tom Coburn, and we focused a fair amount on cyber-security legislation. A couple of Congresses ago, we tried to pass comprehensive cyber-security legislation. It involved a bunch of committees in the Senate, the administration, and we found, at the end of the day, that we could not get it done.

So Dr. Coburn and I started in the last Congress in 2013 and said, "Rather than trying to find a silver bullet on cyber-security, why don't we see if there might be a number of silver BBs that, put together, would actually add up to something significant?" That is what we actually did and passed three or four bills out of committee, and the President signed them into law and significantly strengthened the ability of the Department of Homeland Security to help defend us on the cyber-side.

I like to go big. With respect to comprehensive tax reform, I would like to go big in this instance as well. But at the end of the day, we may not be successful in doing that. We may not be able to find that silver bullet all the way through, but there might be a number of silver BBs. Sometimes we talk around here about getting a half-loaf, a quarter-loaf, or three-quarters of a loaf.

So let us think in terms of either silver BBs or half-loaves. If we cannot get the full loaf or the silver bullet, starting with you, Ms. Olson, what should we at the very least try to get done—not on a temporary basis, not on an extender kind of basis, but on a permanent basis, please?

Ms. OLSON. The constraint is always revenue neutrality. If we could walk away from revenue neutrality or if we could take a perhaps more realistic look at what is sustainably revenue-neutral, that might be a good place to start.

But clearly we need to do something to bring our corporate rate down so it is more closely aligned with that of other governments. So, if you can only do one thing, I would say try to move in the direction of reducing the corporate rate.

Senator CARPER. Thank you. One of the pay-fors we never think much about or talk much about is actually investing in the IRS in terms of people and technology. It is a huge pay-off. I think it is like $10 for every $1 we invest. When are we going to wake up and say, well, maybe we should do that to help pay for some of this stuff?

Mr. Smith?

Mr. SMITH. So I think international reform should focus on making U.S. companies more competitive in the global marketplace, and it should also incentivize job growth in the U.S. So I think very targeted international tax reform, which would focus on repatriation at a reasonable cost, further R&D credits on a consistent basis, some level of patent boxes I would call it, which is a lower tax rate on earnings in the U.S. from utilization of intellectual property, and also a lower general corporate tax rate, would generate jobs growth.

Senator CARPER. Thank you.

Dr. Altshuler?

Dr. ALTSHULER. I agree with Ms. Olson about getting the corporate rate down. I guess if there was another BB, this one might be bigger: thinking about a dividend exemption system with a minimum tax on it.

Senator CARPER. All right. Thanks.

Mr. Shay?

Mr. SHAY. I put three BBs in my testimony. They would be an advance Alternative Minimum Tax, strengthening the corporate residence rules, and addressing some problems that we have today that advantage investment in foreign portfolio stocks rather than U.S. portfolio stocks, which is interactive with U.S. corporate taxation.

Senator CARPER. Thank you.

Ms. Olson, in your testimony you provided, I believe, a chart that sought to compare research tax incentives that are offered in some of the major OECD countries. In it, I think we found that the United States—we are not in the top 20. I do not think we are in the top 25. I think we are at a rate as low as 27. Many of our major trading partners, including China, the U.K., Canada, Japan, all offer, as we know, strong incentives.

To help address this issue, last month one of my colleagues on this committee, Senator Toomey from the neighboring State of Pennsylvania—which was once part of Delaware—and I introduced legislation. We called it The Compete Act. That would address many of the problems by permanently extending, increasing, or simplifying the R&D credit. I view this legislation as the beginning of a dialogue, not the end, on how to reform and improve the Federal tax policy with respect to research.

I would be interested in hearing from the members of this panel about this idea of strengthening our tax incentives to innovate, either from an improved R&D tax credit or supplementing that credit with a so-called patent box. How can we design such a patent

box, and can we do so effectively while also avoiding the base erosion associated with highly mobile income from intangible assets such as patents? I am going to ask you, Ms. Olson, if you would lead off. I would love to hear from Mr. Smith and Dr. Altshuler as well.

Ms. OLSON. Thank you. I think that one of the features of a patent box is that it would serve as an anti-base erosion feature because it would attract income to the U.S. So a well-designed patent box or innovation box that was focused on those kinds of activities and the income from those activities could attract that kind of activity, as well as the income associated with it. So it would be an anti-base erosion feature in itself.

Senator CARPER. All right. Thank you.

Mr. Smith?

Mr. SMITH. So to continue that, I think the combination of continued R&D credits where we generate new ideas and new intellectual property, and then to encourage companies in the U.S. to generate income in the U.S., is the correct combination. I think that is the best combination we could get to and that would certainly—as I said before, I do think that would create jobs.

Senator CARPER. All right. Thanks.

Dr. Altshuler?

Dr. ALTSHULER. I think it is important to note that, under the current system, you can use excess credits to absorb taxes that would be paid on royalties, so the royalties are really not taxed to a large extent under the current system. So I would not even consider a patent box unless we were to go into a dividend exemption-type, territorial-type system.

Senator CARPER. All right. Thank you.

Senator Thune, Mr. Chairman, I know that the witnesses are hungry for another question from me, but I am over my time, so why don't I yield back?

Senator THUNE. Thank you. I thank the Senator from Delaware. We are ready to wrap up here in just a minute. I want to ask one last question.

Mr. Smith, in your testimony, you advocated for moving toward a territorial system by providing for a reduced tax rate on repatriated earnings in the range of 5 percent or slightly higher, and you also said that the tax should not be assessed until the earnings are repatriated to the United States, not when they are earned. Now, in contrast, the President's latest proposal and the proposal from Dr. Altshuler include an immediate tax on foreign earnings, 19 percent under the President, 15 percent under Dr. Altshuler's proposal.

Tell me why you believe that your proposal is a better path forward.

Mr. SMITH. I look at what we are trying to achieve, and I compare it to other international tax reforms from other jurisdictions and other international tax systems in other countries. I cannot see a minimum tax existing in any other foreign tax legislation that I can think of.

So the only complete system of taxing everyone's income, even at different rates, that I can think of is in Brazil, to be honest with you. So I think we should look hard at what other countries have

in terms of tax systems and try to mirror that, because, at the end of the day, I do view this as a competition.

Senator THUNE. What would be the practical implications to your company and your ability to compete with companies based in countries with a territorial tax system if a 19-percent or 15-percent minimum tax were imposed on your foreign earnings?

Mr. SMITH. So we have a lot of foreign earnings generated offshore, about half our earnings. That equates to about $1.5 billion of earnings generated offshore every year. Some of those, we would like to invest in further acquisitions overseas, and so, if there is a minimum tax which basically taxes all our earnings overseas at an additional tax rate, then we have lost some of that money.

So our capacity to go spend that money on other things overseas has gone down, so I think that would not allow us to compete better, that would allow us to compete worse. That is not my ideal for tax reform in the U.S.

Senator THUNE. All right. Well, we appreciate very much, again, your testimony. Thank you for your willingness to come and respond to our questions. This is a complicated subject, but we are long overdue to reform the tax code and to get us to a place where we are more competitive in the global marketplace. Your thoughts and suggestions were very helpful in that regard. So, thanks so much.

With that, this hearing is adjourned.

[Whereupon, at 12:09 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Dr. Rosanne Altshuler, Professor of Economics and Dean of Social and Behavioral Sciences, School of Arts and Sciences, Rutgers University

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is an honor to appear before you today to discuss the very important topic of international tax reform.

I am a Professor in the Economics Department and Dean of Social and Behavioral Sciences at the School of Arts and Sciences of Rutgers University. During various leaves from Rutgers University, I have served as Special Advisor to the Joint Committee on Taxation, Chief Economist for the President's Advisory Panel on Federal Tax Reform in 2005, and Director of the Urban-Brookings Tax Policy Center. In each of these positions, I have advocated the compelling case for tax reform, evaluated the economic consequences of different tax reforms, and studied the implementation issues and transition costs associated with various reforms. My primary area of expertise is international tax policy.

Under our current system, all income of U.S. corporations is subject to U.S. corporate income tax whether it is earned at home or abroad. This "worldwide" or "residence" approach is used by only a handful of advanced countries. All other G–7 countries and all but six other OECD countries (Chile, Ireland, Israel, Mexico, Poland, South Korea) have adopted systems that exempt some (or all) active foreign earnings of resident multinational corporations (MNCs) from home country taxation. These countries are commonly referred to as having "territorial" tax systems. It is more accurate, however, to call this approach a "dividend exemption" system since the removal of home country tax liabilities on active foreign income is typically accomplished by exempting dividend remittances from foreign affiliates to home country parent corporations from tax. In contrast, the United States defers taxation of foreign affiliates' active income until it is distributed as a dividend, but then taxes the income at its full corporate rate and allows a credit for foreign taxes paid on the earnings.

I believe there is broad agreement among policy makers and companies that our current system for taxing the income earned abroad by U.S. corporations is very complex and induces inefficient behavioral responses. The system provides incentives to invest in tangible and intangible capital in some locations instead of others, to engage in costly strategies to avoid U.S. taxes on foreign dividends, and to shift reported income from high- to low-tax locations by using inappropriate transfer prices or paying inadequate royalties. Where the tax burden under U.S. rules exceeds what could be achieved through a non-U.S. parent structure, pressure exists to change the parent corporation's domicile to a foreign jurisdiction.

Many in the United States are calling for reform of our system for taxing international income and support moving to a territorial tax system. I recently worked with Stephen Shay of Harvard Law School and Eric Toder of the Urban-Brookings Tax Policy Center on a report that explores other countries' experiences with territorial tax systems.[1] We examined the approaches and experience of four countries—

---

[1] Rosanne Altshuler, Stephen E. Shay, and Eric J. Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corpora-

Continued

Germany and Australia—both of which have long-standing territorial systems—and the UK and Japan—both of which within the last six years enacted territorial systems by exempting from home country taxation either all or 95 percent of the dividends their resident MNCs receive from their foreign affiliates. We examined the factors that drove the policy choices of these four countries and put forward some lessons we believe the United States can take away from their experiences. In my testimony today, I highlight six conclusions from this work that I believe are important for policy makers in the United States as they contemplate reform of our international tax system. I also briefly discuss the benefits of adopting a reform that would remove the U.S. tax due upon repatriation of foreign profits and impose a minimum tax on foreign income.

1. The classification of tax systems as "worldwide" or "territorial" oversimplifies and does not do justice to the variety of hybrid approaches taken in different countries.

In practice, when exceptions and anti-abuse rules are taken into account, the difference in corporate tax policy between the United States and other advanced economies is nowhere near as stark as the labels "worldwide" and "territorial" suggest. The details of a system are more important than which broad definitional category is applied to a particular system.

All tax systems are hybrid systems that tax at reduced effective rates some foreign business income. Under the current U.S. "worldwide" system, MNCs are allowed to defer tax on most income earned in their foreign subsidiaries until that income is repatriated as a dividend to the U.S. parent company and are provided a liberal credit for foreign income taxes paid. As a result of deferral and the foreign tax credit, the United States collects little tax on the dividends its MNCs receive from their foreign affiliates.[2] Under the prior "worldwide" UK and Japanese systems, in which they also deferred tax on foreign affiliate earnings, their MNCs could bring back foreign earnings through related party loans without it being treated as a taxable repatriation. Most "territorial" countries impose tax on some foreign-source income as accrued in order to protect their domestic corporate tax base. In any assessment of international tax policy, as in so much else in taxation, the devil is in the details.

2. The circumstances that have caused other countries to maintain or introduce territorial systems do not necessarily apply to the United States. Therefore, others' experiences do not necessarily dictate that the United States should follow the same path.

The countries we studied (Australia, Germany, Japan and the UK) differed greatly in the extent to which they weighed conflicting policy concerns, such as effects on domestic investment, residence decisions of MNCs, tax avoidance through profit shifting, the burden of the tax due upon repatriation of foreign profits, and taxation of inbound investments. Countries also differed as to their levels of concern about potential budgetary effects of corporate tax policy changes. We were somewhat surprised to discover that the policy decisions of the countries we studied do not appear to have been based on analysis of how foreign source income was effectively being taxed. In other words, the changes do not seem to have been driven by analysis of administrative data and seem, instead, to have been driven by anecdotal evidence to the extent decisions were "evidence based."

3. The tax policies of countries with dividend exemption systems have been greatly influenced by their separate individual circumstances.

As a net capital importing country, Australia's main goal for its corporate tax has been to collect taxes from foreign corporate investors. There is less concern with

---

tions," *Urban-Brookings Tax Policy Center Research Paper,* January 21, 2015, *http://www.taxpolicycenter.org/UploadedPDF/2000077-lessons-the-us-can-learn-from-other-countries.pdf.*

[2] Because of deferral, the foreign tax credit, and the electivity of operating through a foreign branch, the United States does not collect much corporate tax in any form on foreign income earned from operating directly in another country. In recent work using U.S. Treasury tax data, Harry Grubert and I estimate that the United States collected $32 billion of revenue on all categories of corporate foreign source income in 2006. This amount was approximately nine percent of 2006 corporate tax revenues but less than four percent of all foreign-source income of U.S. MNCs (including profits deferred abroad, but before allocated parent expense). U.S. taxes paid on repatriated dividends accounted for a very small portion of this revenue. The remainder came from taxes on royalties, portfolio income, export income and income from foreign branches. See, Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal,* September 2013, 66(3), 671–712.

treatment of outbound investment by Australian companies. Australia has an imputation system, which allows domestic, but not foreign shareholders, to claim credits for domestic but not foreign corporate taxes paid by Australian companies. This in part may reduce tax avoidance by Australian companies through shifting profits overseas, because Australian shareholders are not allowed credits if domestic corporate taxes have not been paid.

Germany adopted their dividend exemption system many years ago in order to foster foreign investment by German companies. Other European Union (EU) countries also had exemption systems, which influenced German practice. German anti-avoidance rules appear to be more effective than most in limiting profit shifting by German-based companies, except to the extent that these rules are limited to conform to EU rules.[3]

Japan adopted an exemption system in 2009 to make its companies more competitive and encourage them to bring back accrued overseas profits to Japan. The Japanese also believed that exemption would be simpler to administer than the system they had in place. A notable feature of the Japanese tax environment is a compliant international tax planning culture. Advisers report that Japanese MNCs are not aggressive tax planners. Accordingly, the Japanese government was not concerned that eliminating taxes on repatriated dividends would encourage income shifting and base erosion behavior by their MNCs. Japan did not enact any new anti-avoidance rules to accompany the switch to a territorial system and did not adopt a transition tax on repatriations from pre-effective date profits.

The United Kingdom went to a territorial tax system in 2010 and lowered their top corporate tax rate to 21 percent. It also enacted "patent box" legislation that reduced the tax rate on intangible income to 10 percent. Like Japan, the United Kingdom applied their new dividend exemption system to distributions of foreign earnings prior to the effective date. But the UK moves had much different motivations than the Japanese reforms. The United Kingdom was mainly concerned with losing corporate headquarters. This was facilitated by a number of factors including the proximity of the United Kingdom to other countries (Ireland, Luxembourg) with lower corporate tax rates and territorial systems, and the absence of any anti-inversion rules in the United Kingdom (and EU restrictions against adopting such rules). The United Kingdom was less concerned about tax avoidance and had close to the equivalence of an exemption system before the change because of rules that allowed their MNCs to return borrowed funds to their shareholders without paying the repatriation tax. In addition to tax competition from European countries for corporate headquarters, the decision of the United Kingdom to adopt dividend exemption seems to have been driven by requirements to satisfy European Court of Justice case law interpreting EU treaties and the recession brought on by the 2008 financial global crisis.

4. The burden of the tax due upon repatriation of foreign earnings may be a lot higher in the United States than it was in the United Kingdom and Japan before they adopted dividend exemption systems.

Deferral of U.S. tax allows foreign business income of U.S. MNCs to be taxed at a lower effective rate than it would be if it were earned in the United States. When combined with financial accounting rules that effectively treat deferred earnings as permanently exempt, deferral creates a "lockout" effect with associated efficiency costs. Corporations will engage in inefficient behavior—they will take actions that they would not find attractive were it not for the tax—to avoid the tax due upon repatriation and the associated reduction in after-tax book income. For example, a parent corporation that wants to invest in a project in the United States, distribute dividends to shareholders or buy back its shares may borrow at home instead of remitting foreign profits in order to extend the deferral of U.S. tax on foreign earnings. This maneuver allows the U.S. parent to defer the U.S. corporate tax, but raises the cost of capital for domestic uses.

The burden of the tax on foreign subsidiary dividends is a key issue for understanding both the benefits and detriments of moving to a dividend exemption sys-

[3] Germany is concerned about avoidance of German tax on inbound investment, which their rules to limit tax avoidance by German-resident companies cannot combat. There is a concern that this gives foreign companies a competitive advantage over domestic-based firms in the German market.

tem and how the current system differs from dividend exemption.[4] The burden of the tax includes both the actual tax paid upon repatriation and the implicit costs of deferring income which likely increase as retentions abroad grow. These implicit costs include, for example, the cost of using parent debt to finance domestic projects as a substitute for foreign profits (which will increase as debt on the parent's balance sheet expands), payments to tax planners, foregone domestic investment opportunities and foreign acquisitions that may not have been undertaken in the absence of the tax.

In a recent paper, Harry Grubert of the U.S. Treasury Department and I used data from the U.S. Treasury tax files to derive an estimate of the cost of deferring foreign income that takes into account the growing stock of profits retained abroad.[5, 6] This implicit cost can be thought of as the amount a company would be willing to pay to have the repatriation tax on an extra dollar of foreign earnings removed. Our work suggests that the implicit cost of the tax on foreign profits for a highly profitable company is about five to seven percentage points today. This burden is higher than previous estimates and increases as deferrals accumulate abroad.

As mentioned above, the United Kingdom and Japan allowed corporations to move foreign profits from affiliates to parents without any home country tax via subsidiary loans to or investment in parent corporations.[7] In those countries, it seems that it was relatively easy for parent corporations to access foreign profits without paying home country tax. The U.S. tax code, however, would treat such loans or investments as distributions with respect to stock and subject them to U.S. tax to the extent of un-repatriated earnings.

I am not aware of any estimates of the burden of repatriation taxes in the United Kingdom or Japan, but my understanding of their systems suggests that the burden of the tax on foreign dividends in those countries was much smaller than it is in the United States. For this reason, their decisions to eliminate the tax on active foreign earnings offer relatively little direct guidance for resolving the disagreement in the United States over the optimal approach to reducing this key burden of the current system.

5. The fact that the United States raises relatively little corporate tax revenue as a share of GDP than other countries while having the highest statutory corporate rate in the OECD has multiple explanations and does not necessarily suggest that U.S.-based companies in any given industry are more aggressive at income-shifting than foreign-based companies.

According to the OECD Tax Database, only Germany had a lower ratio of corporate receipts to GDP than the United States in 2012 (the most recent year reported).[8] This ratio was 1.8 percent for Germany, 2.5 percent for the United States, 2.7 percent for the UK, 3.7 percent for Japan and 5.2 percent for Australia. The United States had the second highest corporate rate at 39.1 percent (including subnational taxes) among the five countries in 2012 with Japan at the top at 39.5 percent. Germany and Australia had rates of 30.2 and 30 percent, respectively, and the United Kingdom had a rate 24 percent. (Since 2012, the Japanese rate has fallen to 37 percent and the rate in the United Kingdom has been reduced to 21 percent.)

One reason the United States raises little corporate revenue as a share of GDP with a relatively high corporate tax rate is that a relatively large share of business activity in the United States comes from firms that do not pay corporate income tax. We estimate that the United States among the five countries has the lowest share

---

[4] Pressure from U.S. MNCs arguing that the burden was costly to their business operations and a desire by Congress to induce U.S. MNCs to reinvest accrued foreign profits in the United States resulted in a "repatriation tax holiday" in 2005. Not surprisingly, pressure for a similar tax holiday surfaced not long after the holiday expired and has continued.

[5] See Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal,* September 2013, 66(3), 671–712.

[6] A recent analysis reported in Bloomberg News estimates the stock of profits held abroad by U.S. companies at $2.1 trillion. See *http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes.*

[7] Section 956 of the Internal Revenue Code prevents companies from avoiding home country taxation while implicitly receiving the benefits of the foreign earnings of their controlled foreign affiliates through loans or investments in U.S. property by treating these transactions as constructive dividends. I am not aware of these types of rules being in place in any other OECD country.

[8] OECD, *Revenue Statistics 2014,* 2014, OECD Publishing, Paris, *http://www.oecd-ilibrary.org/taxation/revenue-statistics-2014_rev_stats-2014-en-fr.*

of business profits that comes from companies that are subject to a corporate profits tax (34 percent). Germany appears also to have a relatively low share of business profits subject to the corporate tax (45 percent). In contrast, very large shares of business profits in Japan (87 percent), Australia (82 percent), and the United Kingdom (80 percent) are subject to their country's corporate income tax.[9]

A second reason that the United States raises relatively little revenue as a share of GDP from corporate taxes in spite of its high statutory corporate rate is the extent of tax preferences it allows in relation to business income. Based on estimates and projections reported by the U.S. Office of Management and Budget, we calculate that corporate tax expenditures, excluding international provisions, will reduce U.S. corporate tax receipts by about 15 percent between fiscal years 2015 and 2019.[10] Including international provisions would raise this figure to 23 percent, but the major international tax expenditure, deferral, is less generous than the exemption of foreign-source income in the tax laws of the four comparison countries. While the domestic tax preferences reduce the effective U.S. corporate rate below the statutory rate, the effective corporate rate is also lower than the statutory rate in most other OECD countries, although less so. The ratio of the effective rate to statutory rates is slightly lower in the United States than it is for the four comparison countries.[11]

To what extent does income shifting explain the comparatively low level of corporate receipts as a share of GDP relative to the high U.S. statutory rate? The United States does have relatively large high-tech and pharmaceutical sectors, which are the ones mostly likely to have a large share of their capital in the form intangible assets that are easy to shift to entities in low-tax jurisdictions. While there is evidence of income shifting by U.S. companies, there are insufficient comparable data on companies from other countries to conclude that U.S. companies are more or less aggressive than their peer competitors from other countries.[12]

6. The ability of the U.S. to retain higher corporate tax rates and tougher rules on foreign income is declining.

The United States is subject to many of the same pressures facing other countries that have lowered corporate tax rates and have eliminated taxation of repatriated dividends. The United States faces growing competition as an investment location versus jurisdictions with lower corporate tax rates. U.S.-based MNCs face growing competition from MNCs based in countries with exemption systems.[13]

The advantages of foreign residence have increased incentives for some U.S.-based firms to "re-domicile" as foreign-based firms. The rising costs of repatriations as U.S. firms accumulate more cash overseas and foreign corporate income tax rates decline, combined with the ability of expatriated firms to circumvent taxes that would otherwise be payable on repatriations from accrued assets in U.S. controlled foreign subsidiaries puts increased pressure on firms to consider giving up U.S. residence.[14] And foreign-residence makes it easier for corporations to strip income out

---

[9] For further information and figures see Rosanne Altshuler, Stephen E. Shay, and Eric J. Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," *Urban-Brookings Tax Policy Center Research Paper,* January 21, 2015, *http://www.taxpolicycenter.org/UploadedPDF/2000077-lessons-the-us-can-learn-from-other-countries.pdf.*

[10] U.S. Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2015,* 2014, Table 14.2: 210–215.

[11] See Kevin A. Hassett and Aparna Mathur, "Report Card on Effective Corporate Tax Rates: U.S. Gets an F," American Enterprise Institute, February 9, 2011.

[12] For the most rigorous evidence of income shifting of U.S. multinational corporations, see Harry Grubert, "Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales are Being Globalized," *National Tax Journal,* June 2012. Grubert demonstrates using Treasury tax data that the differential between U.S. and foreign effective tax rates has a significant effect on the share of U.S. multinational income abroad and that this effect works primarily thorough changes in domestic and foreign profit margins and not through the location of sales.

[13] No country, however, has a pure territorial system. Countries with territorial tax systems have adopted rules to prevent abuse and protect the corporate tax base and one must take these provisions into account when comparing the "competitiveness," for example, of different systems. At least on the surface, however, it does appear that other countries anti-abuse rules are not more robust than U.S. rules (Brian J. Arnold, "A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules," *Tax Law Review,* Spring 2012).

[14] Edward D. Kleinbard, "Competitiveness Has Nothing to Do with It," *Tax Notes,* September 1, 2014.

of the United States through earnings stripping techniques involving interest and royalties.[15]

The U.S. market is large and has enough unique productive resources that companies will invest here (albeit somewhat less) even if U.S. corporate rates are higher than elsewhere. The United States has some of the world's leading MNCs with unique assets in certain areas (e.g., high-tech, finance, and retailing). But as the economic differences between the United States and other countries narrow and the United States share of world output declines, the ability of the United States to sustain "U.S. tax exceptionalism" will decline.

CONCLUSION

In the last two decades differences between the United States and other countries' tax systems have widened. The United States is now the only major country that imposes a home country tax on foreign business income when it is returned to home country parents. And there are other ways that the United States has become more different that are also important: the United States is the only country that does not employ a VAT to raise revenues; statutory and effective tax rates around the world have continued to decline relative to U.S. rates, sharpening the "competitiveness" issue; and the share of business income in the United States that is taxed at the corporate level has been declining since the 1980s and today is less than 40 percent, while in most other countries business income is typically subject to corporate income tax. At the same time, emerging economies have acquired importance in international tax policy discussions and generally have adopted the perspective of a host country seeking to attract inbound investment. Accumulating evidence that MNCs are shifting more of their reported income to very low-tax countries is driving discussion of reform around the world and the OECD has initiated a Base Erosion and Profit Shifting project (BEPS) to develop coordinated actions to prevent the erosion of the corporate tax base.

There is no question that the global tax environment has changed greatly and will continue to do so. One of the lessons of my study with Stephen Shay and Eric Toder is that the United States need not follow others tax policies. But that does not mean that our reform process should be done in a vacuum. It is fundamental to understand the forces that have shaped the reforms of our competitors and recognize that while our economies are different we do, indeed, face many of the same pressures.

In a recent paper, Harry Grubert and I evaluated a variety of reforms and proposed one that makes improvements along a number of behavioral margins that are distorted under the current tax system.[16] We would start by eliminating the lockout effect by exempting all foreign earnings sent home via dividends from U.S. tax. This reduces wasteful tax planning and simplifies the system. Then we would impose a minimum tax of, say, 15 percent on foreign income. As a result, companies would lose some of the tax benefits they enjoy from placing valuable intellectual property like patents in tax havens and from other methods of income shifting. If companies continue to route income to havens, at least the U.S. would collect some revenue.

Our reform would restore some sanity to the system. For example, investments in low-tax countries are now effectively subsidized due to the opportunities for income shifting they create. Under our minimum tax reform these investments would face positive U.S. effective tax rates. The minimum tax could be imposed on a per country basis but it could also be on an overall basis which would be much simpler. As an alternative to an active business test, the tax could effectively exempt the normal profits companies earn on their investments abroad by allowing them to deduct their capital costs. That way the tax would apply only to foreign profits above the normal cost of capital and companies would not be discouraged from taking advantage of profitable opportunities abroad. Only "super" profits above the normal return—typically generated from intellectual property—that are most easily shifted would be subject to the minimum tax. There are other options. But my analysis with Harry Grubert suggests that combining a minimum tax with dividend exemption can make improvements across many dimensions including the lockout effect, income shifting, the choice of location and complexity.

---

[15] Stephen E. Shay, 2014. "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations," *Tax Notes,* July 28, 2014.

[16] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal,* September 2013, 66(3), 671–712.

I applaud the Senate Committee on Finance for holding this hearing on building a competitive U.S. international tax system and urge the Committee to tackle the challenge of reforming our system.

Thank you. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R–Utah) today delivered the following opening statement at a committee hearing on the international tax system:

The committee will come to order.

I want to welcome everyone to today's hearing on Building a Competitive U.S. International Tax System. I also want to thank our witnesses for appearing before the committee today.

Reforming our international tax system is a critical step on the road toward comprehensive tax reform. Not surprisingly, the failures of our current system get a lot of attention. That's why Senator Wyden and I designated one of our five tax reform working groups to specifically look into this issue.

I know that my colleagues serving on that working group—and all of our working groups—are looking very closely at all the relevant details. I look forward to their recommendations.

As we look at our international tax system, our primary goals should be to make the U.S. a better place to do business and to allow American job creators to more effectively compete with their foreign counterparts in the world marketplace.

Our corporate tax rate has been the highest in the developed world and effective tax rates facing U.S. corporations are higher than average. In my opinion, our high corporate tax rate has to come down significantly. I think most of my colleagues—on both sides of the aisle—would agree with that.

In addition, our current system creates incentives that lock out earnings made by U.S. multinationals abroad and keep those earnings from being reinvested domestically. This also needs to be addressed in tax reform.

Additionally, I'll note that the tax base is much more mobile than it used to be. For example, thanks to advances in technology and markets, capital and labor have become increasingly more mobile. And, the most mobile assets of all—intangible assets—have taken up a greater share of wealth around the world. The problem we've seen is that intangible assets and property can easily be moved from the United States to another country—particularly if that country has a lower tax burden.

This is a disturbing trend, one that I think all of us would like to see reversed.

Some, like President Obama in his most recent budget, have responded to this trend by calling for higher U.S. taxation of foreign-source income, claiming that, by extending the reach of U.S. taxes, we can eliminate incentives for businesses to move income-producing assets to other countries.

The problem, of course, is that assets aren't the only thing that can be moved from one country to another. Companies themselves can also migrate away from our overly burdensome tax environment. And, we've seen that with the recent wave of inversions. Indeed, many companies have already decided that our current regime of worldwide taxation with absurdly high tax rates is simply too onerous and have opted to locate their tax domiciles in countries with lower rates and territorial tax systems.

In other words, if we're serious about keeping assets and companies in the U.S., we should not be looking to increase the burdens imposed by our international tax system. Instead, we should be looking to make our system more competitive.

Not only must our corporate tax rate come down across the board, we should also shift significantly in the direction of a territorial tax system. If we want companies to remain in the U.S. or to incorporate here to begin with, we should not build figurative or legal walls around America—we should fix our broken tax code.

We have a lot to discuss here today. I know that there are some differing opinions among members of the committee on these issues—particularly as we talk about the

merits of a worldwide versus a territorial tax system. But, I think we've assembled a panel that will help us get to some answers on this front and, hopefully, aid us in our efforts to reach consensus as we tackle this vital element of tax reform.

With that, I now turn it to Ranking Member Wyden for his opening statement.

PREPARED STATEMENT OF HON. PAMELA F. OLSON, U.S. DEPUTY TAX LEADER AND WASHINGTON NATIONAL TAX SERVICES LEADER, PRICEWATERHOUSECOOPERS LLP

Chairman Hatch, Ranking Member Wyden, and distinguished members of the Committee, I appreciate the opportunity to appear this morning as the Committee considers the importance of ensuring that our Nation's tax laws serve to make the United States competitive globally. I had the honor of serving as Assistant Treasury Secretary for tax policy from 2002 to 2004, and am currently U.S. Deputy Tax Leader of PricewaterhouseCoopers LLP and leader of PwC's Washington National Tax Services practice. I am appearing on my own behalf and not on behalf of PwC or any client. The views I express are my own.

INTRODUCTION

The subject of this hearing is the legislative actions necessary for a competitive U.S. international tax system, and I applaud the Committee for holding the hearing. It is my view that reform of our international tax rules is imperative to promoting the economic growth that will yield increased job opportunities and higher wages for the American people. Our tax system should serve to facilitate, not impede, the efficient, effective, and successful operation of American businesses in today's global marketplace. Success for America's globally engaged businesses is essential to the success of their workers as well as the many businesses on which they depend for goods and services. Unfortunately, it is increasingly the case that the divergence of our current tax system from the systems of the rest of the world makes it a barrier to their success and drives business away.

My testimony is focused on tax policy issues specific to making the United States a more hospitable environment for headquartering global operations and for domestic investment, both of which will lead to more American jobs and a rising standard of living. My testimony describes changes in the global economy that make international tax reform vital, changes in other countries' tax systems, the features of our tax system most in need of reform, and the implications and risks to the United States and U.S. businesses of the global effort to address base erosion and profit shifting (BEPS) led by the Organisation for Economic Cooperation and Development (OECD).

A CHANGING GLOBAL ECONOMY

The changing global economic landscape must set the stage for considering the tax reforms necessary for American business to compete and succeed. But first some background is useful on the age of our international tax framework. Since the inception of the income tax in 1913, the United States has taken a worldwide approach to taxing the foreign income of U.S. companies and their subsidiaries. Shortly after enactment, Congress added a foreign tax credit to reduce the adverse economic impact of a second layer of tax on foreign income. Limitations on the foreign tax credit soon followed. The general rule is that foreign income is subject to U.S. tax only when it is repatriated to the United States, but there are many exceptions that dictate current U.S. tax on foreign income. Those exceptions are found in subpart F of the Internal Revenue Code and date to 1962. Although a number of changes have been made to the subpart F rules over the last 50 years, the rules remain locked in a time when global business operations differed significantly from today. Congress' reform of the rules to reflect changes in the global economy, such as the exception for active financing income, has been limited and temporary. We have a tax system designed for rotary phones and telephone operators while we carry smartphones with 1,000 times the processing power of the Apollo Guidance Computer that put man on the moon. The 21st century is calling. The rest of the world has answered and enacted a tax system that fits it. It is time we did the same.

The global economy has changed enormously since 1962. Globalization—the growing interdependence of countries' economies—has resulted from increasing international mobility and cross-border flows of trade, finance, investment, information, and ideas. Technology has continued to accelerate the growth of the worldwide marketplace for goods and services. Advances in communication, information technology,

and transportation have dramatically reduced the cost and time it takes to move goods, capital, information, and people around the world. In this global marketplace, firms differentiate themselves by being nimble around the globe and by innovating faster than their competitors.

The U.S. role in the global economy has changed as well over the last 50 years. In 1962, the United States was the dominant economy, accounting for over half of all multinational investment in the world. U.S. dominance has diminished as the significance of the rest of the developed world in the global economy has grown. In recent years, there has been a massive shift in economic power to emerging markets. PwC projects that the combined GDP of G–7 countries including the United States will grow from $29 trillion in 2009 to $69.3 trillion by 2050, while the combined GDP of seven emerging economies (the E–7) that include China, India, and Brazil will grow from $20.9 trillion to $138.2 trillion over the same period.

The changing U.S. role reflects less the waning of the U.S. economy than the rapid rise from poverty of the most populous parts of the globe. As President Obama noted in his State of the Union address, 95 percent of the world's customers live outside the United States. That represents more than 80 percent of the world's purchasing power. U.S. businesses can't serve those rapidly growing markets by staying home. Facilitating U.S. businesses in serving those markets increases the value of the assets of American businesses and leads to increased American jobs.

To thrive in the changing global marketplace, it is critical that we ensure our international tax system promotes the competiveness of U.S. business in the global marketplace. A tax system that allows U.S. companies to serve foreign markets more effectively will translate to increased success for American businesses, increased American jobs, and higher wages.

Today, there are few U.S.-based businesses unaffected, directly or indirectly, by the operation of the U.S. international tax rules. Advances in communication, information technology, and transportation have opened the global marketplace to small and medium sized businesses along with large globally engaged business. Businesses operating domestically provide goods and services to other businesses operating internationally. According to a recent study, the typical U.S. multinational business in 2008 bought goods and services from 6,246 American small businesses; collectively U.S. multinationals purchased an estimated $1.52 trillion in intermediate inputs from American small businesses.[1] Further, many small and medium sized businesses have their own direct foreign operations. Commerce Department data show that 26 percent of U.S. multinational businesses meet the U.S. government definition of a small or medium sized business.[2] The result is that all businesses, whether large or small, benefit from a tax system that promotes the global competitiveness of American businesses, and their success is linked to a strong global economy.

A globally competitive tax system is critical not only for U.S.-headquartered companies to succeed but also to attract continued investment by foreign-headquartered businesses in the United States. Today the U.S. operations of foreign companies employ 5.8 million American workers and account for 21.9 percent of all U.S. exports of goods.[3] Tax policies that attract foreign capital to the United States will create American jobs and should be part of building a competitive U.S. tax system.

A CHANGING GLOBAL VIEW OF CORPORATE TAXES

When the United States had a dominant role in the global economy, we were free to make decisions about our tax system with little regard to what the rest of the world did. As a practical matter, our trade partners generally followed our lead in tax policy. That is no longer the case.

Just as the global economy has changed, tax systems around the world have evolved. Governments in the developed and developing world have adopted policies that reflect a changing view of corporate income taxes. This changing view may have been occasioned by economics or practicality, but as discussed below, the result is a growing gap between the United States and the rest of the world.

---

[1] Matthew J. Slaughter, "Mutual Benefits, Shared Growth: Small and Large Companies Working Together," a report prepared for the Business Roundtable, 2010.
[2] Matthew J. Slaughter, "American Companies and Global Supply Networks," prepared for the Business Roundtable, 2013.
[3] U.S. Department of Commerce, Bureau of Economic Analysis, November 2014.

In recent decades, the share of GDP attributable to intangible assets, such as patents, know-how, and copyrights, has increased substantially. Unlike property, plant, and equipment, intangible assets are highly mobile and more likely to be exploitable on a global basis, increasing their value. This shift has been accompanied by the reorganization of economic activity around global value chains and strategic networks that flow across national borders. It has been estimated that roughly one-third of world trade takes place within multinational companies.[4] Trade between related parties accounted for 47% ($172 billion) of total EU–U.S. merchandise trade in 2002 and increased to 50% ($307 billion) by 2012.[5]

The rise in the value of intangibles and the interconnected nature of the global economy leads to two points. The first point is that it is more difficult today to measure income earned within a country's borders and to tax it. Manuel Castells observed that:

> [A]s accounting of value added in an international production system becomes increasingly cumbersome, a new fiscal crisis of the state arises, as the expression of a contradiction between the internationalization of investment, production, and consumption, on the one hand, and the national basis of taxation systems on the other.[6]

As a practical matter, other countries have dealt with this issue by relying more heavily on consumption based taxes, such as value-added or goods and services taxes, that are applied to a tax base that is more easily measured and less mobile, to fund the government.

The second point is tied to the rise in economic power of the rest of the world, which has broadened and deepened the markets in which capital can be raised and profitably invested. Capital is mobile. It is more easily deployed in a globally interconnected economy where much of the value comes from intangible assets that are also mobile.

Many foreign governments have recognized the global mobility of capital and intangible assets and have come to view business income taxes as a competitive tool that can be used to attract investment. By reducing statutory corporate income tax rates, adding incentives for research and development, innovation, and knowledge creation, and adopting territorial systems that limit the income tax to activities within their borders, governments have sought to attract capital that will yield jobs, particularly high-skilled jobs for scientists, engineers, and corporate managers. They've recognized the benefits that flow from making their country hospitable to investment from globally engaged businesses. These benefits include the creation of sustainable jobs, both directly and through the goods and services the businesses and their employees purchase.

There are other reasons for governments to move away from reliance on the corporate income tax as a significant source of revenue. They include the fact that capital mobility affects the reliability of the corporate income tax and makes proposals to increase taxes on corporate income less likely to succeed. They also include the fact that economists have concluded that consumption-based taxes are the most efficient way of raising revenue, and the corporate income tax the most destructive form. These conclusions appear to have been accepted by foreign governments. Their increased reliance on consumption-based taxes positions them to raise the revenue required to fund government needs on a basis more conducive to economic growth than is the case in the United States.

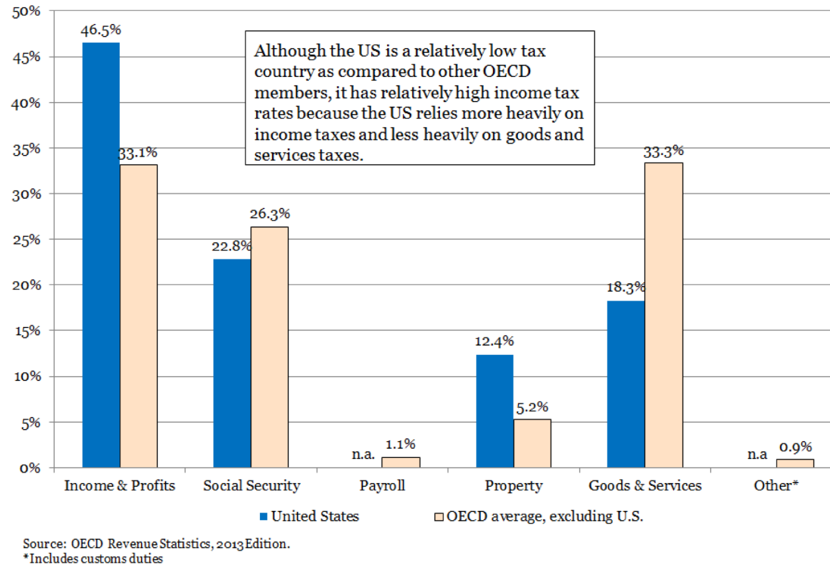
The extent to which U.S. tax policy is out of sync with the competitive and pro-growth tax policies of other nations can be seen in the chart below which shows the federal government's primary reliance on income taxes in contrast to most of the world's major economies, which rely to a significant degree on consumption taxes.

[4] Pol Antràs, "Firms, Contracts, and Trade Structure," Quarterly Journal of Economics (2003), p. 1375.

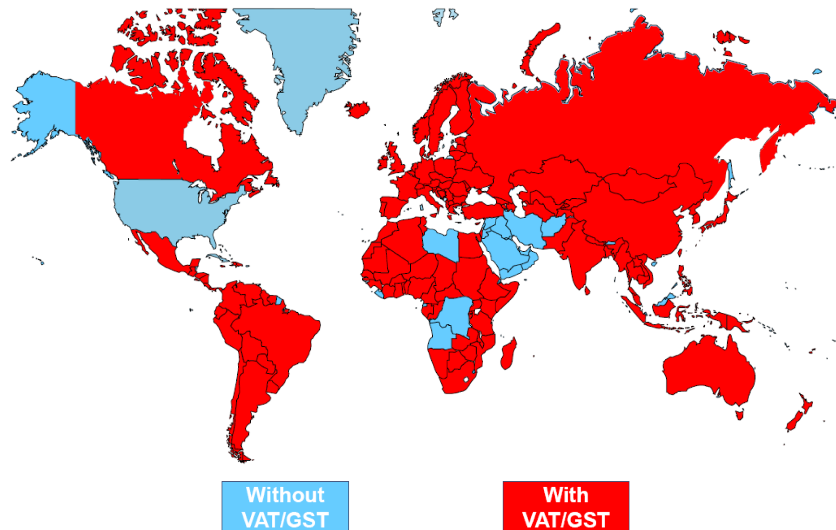
[5] C. Lakatos and T. Fukui, "EU–U.S. Economic Linkages: The Role of Multinationals and Intra-firm Trade," Trade, Chief Economist Note, Issue 2, European Commission (2013).

[6] Castells, *The Power of Identity, The Information Age: Economy, Society, and Culture, Vol. II* (2nd ed., 2010), p. 306.

FEDERAL/STATE TAXES AS A SHARE OF TOTAL TAXATION, OECD, 2011



Reliance on consumption taxes is not limited to OECD countries. Their widespread usage can be seen in the map below.



Although consumption taxes are often criticized as regressive, recent economic studies have concluded that the corporate income tax falls on labor to a significant extent. This has been recognized by economists at the Congressional Budget Office, the Joint Committee on Taxation, and the U.S. Treasury Department. Estimates of the share borne by labor range from 20 percent to 70 percent.

Joseph Sneed observed nearly six decades ago:

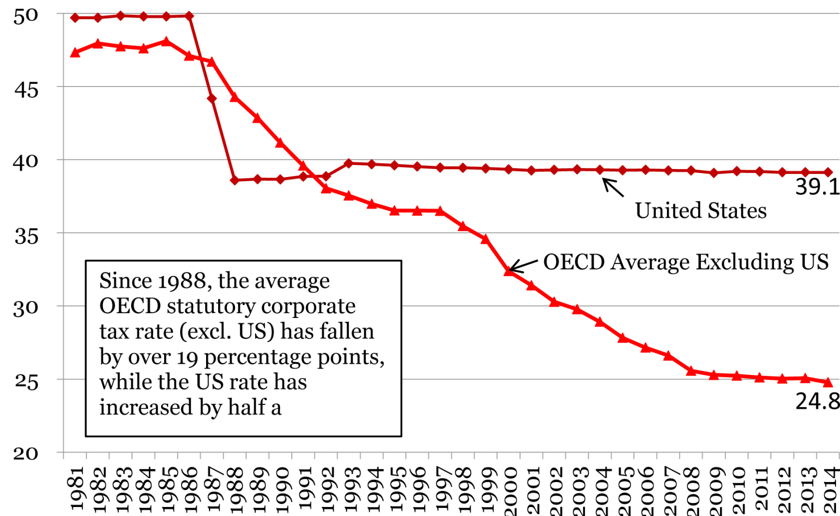
A tax on corporate income at the corporate level has a deep appeal to many people and assertions addressed to them to the effect that they, and not the corporations, pay the tax make little headway against the observable fact that corporate accountants prepare the returns and corporate treasurers write the checks in payment of the tax. To them a tax on corporate income is a tax on corporations which, more often than not in their opinion, are sufficiently evil to deserve their fate.[7]

Despite the economic studies, there continues to be a widespread and persistent perception that the corporate tax is somehow borne by the corporation without effect on its employees, customers, or shareholders, and without impact on its ability to succeed in an increasingly competitive global economy. When considering how to build a competitive international tax system that will create jobs in the United States, it will be important for the Committee to lay that myth aside. The reality is that our globally engaged businesses are the engine that delivers the products and services of America's workers to the world and the benefits of globalization to America's consumers.

U.S. TAX POLICY IS OUT OF SYNC WITH GLOBAL TRENDS

An understanding of the full impact of U.S. international tax rules must begin by recognizing the fact that the United States has the highest statutory tax rate among major global economies. The top U.S. statutory corporate tax rate, including state corporate income tax, is 39.1 percent, more than 14 percentage points higher than the 2014 average (24.8 percent) for other OECD countries, and 10 percentage points higher than the average (29.0 percent) for the other G7 countries.

TOP STATUTORY (FEDERAL AND STATE) CORPORATE TAX RATES, OECD 1981–2014



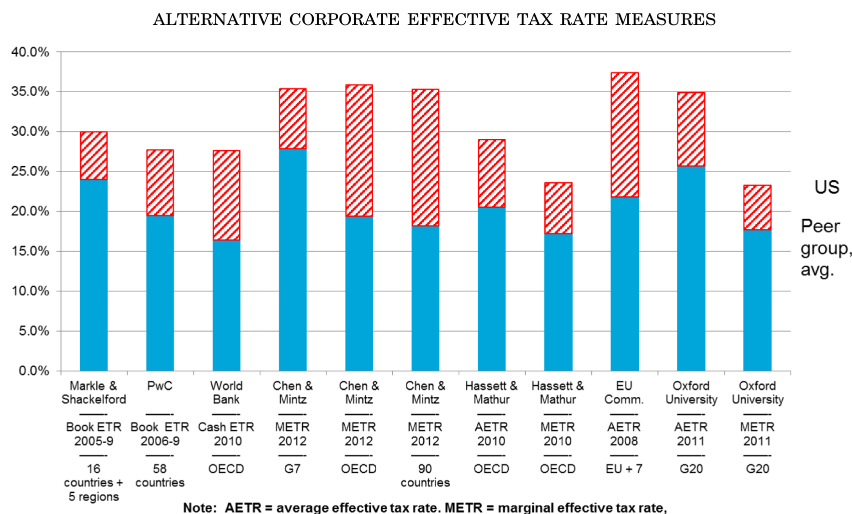
Other nations have continued to implement tax reforms that will result in the non-U.S. OECD average rate falling even lower in 2015. For example, the United Kingdom is scheduled to reduce its corporate rate from 21 to 20 percent and Japan is reducing its combined national and local corporate tax rate from 34.62 to 32.11 percent in April. Portugal and Spain also are scheduled to reduce their corporate tax rates, while among OECD countries, only Chile is moving to increase its rate to 27 percent by 2018—still far below the U.S. statutory rate.

U.S. effective tax rates also are high relative to other developed economies. For example, a recent report issued by the Tax Foundation found that the United States

[7] Joseph Sneed, "Major Objectives and Guides for Income Tax Reform," in *Tax Revision Compendium,* Committee Print, Committee on Ways and Means (GPO, November 16, 1959), p. 68.

has the second highest marginal effective tax rate on corporate investment in the developed world at 35.3 percent—behind only France.[8] The chart below references several recent studies that have consistently demonstrated the high effective tax rate of the United States relative to other peer groups.

ALTERNATIVE CORPORATE EFFECTIVE TAX RATE MEASURES



U.S. international tax rules also are out of sync with the rest of the world. As noted above, the vast majority of foreign governments have shifted their income taxes from a worldwide basis to a territorial basis that limits the tax base to income from activity within their borders; they have enacted anti-base erosion measures, but those measures are aimed at protecting their domestic tax base from erosion, not at preservation of a worldwide base. Every other G–7 country and 28 of the other 33 OECD member countries have international tax rules that allow their resident companies to repatriate active foreign earnings to their home country without paying a significant additional domestic tax. This approach, sometimes referred to as a "participation exemption" or "dividend exemption" tax regime, differs markedly from the U.S. worldwide tax system in which the foreign earnings of U.S. companies are subject to U.S. corporate tax with a credit for taxes paid to the foreign jurisdiction.

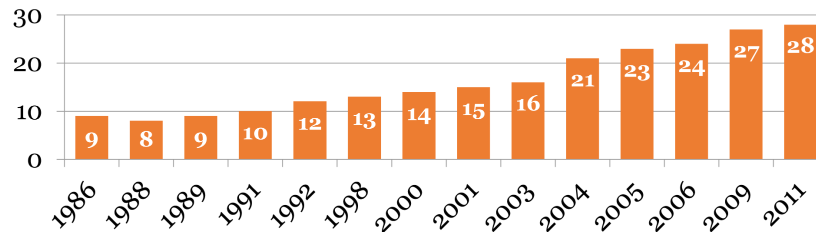
The United Kingdom and Japan, in 2009, became the most recent major economies to adopt territorial tax systems, leaving the United States as the only G–7 country that has not adopted a modern territorial tax system. Of the 28 OECD countries with territorial tax systems, only two—New Zealand and Finland—have switched from territorial to worldwide tax systems, and both nations subsequently switched back to territorial tax systems. The growth in the number of OECD nations adopting territorial tax systems since 1986 when the United States last overhauled its tax laws is shown in the chart below.[9]

---

[8] Jack M. Mintz and Duanjie Chen, "U.S. Corporate Taxation: Prime for Reform," Tax Foundation Special Report, Feb. 2015, No. 228.

[9] Source: PwC report, *Evolution of Territorial Tax Systems in the OECD,* prepared for the Technology CEO Council, April 2, 2013.

NUMBER OF OECD COUNTRIES WITH DIVIDEND EXEMPTION (TERRITORIAL) SYSTEMS, 1986–2011



The high U.S. statutory corporate income tax rate in combination with the worldwide income tax system has negative consequences for American businesses and workers in an increasingly global economy. First, it discourages both U.S. and foreign companies from locating their more profitable assets and operations inside the United States. Second, it encourages both U.S. and foreign companies to locate their borrowing in the United States, as the value of interest deductions is greater against a higher corporate tax rate. Third, it discourages U.S. companies from remitting foreign profits to the United States.

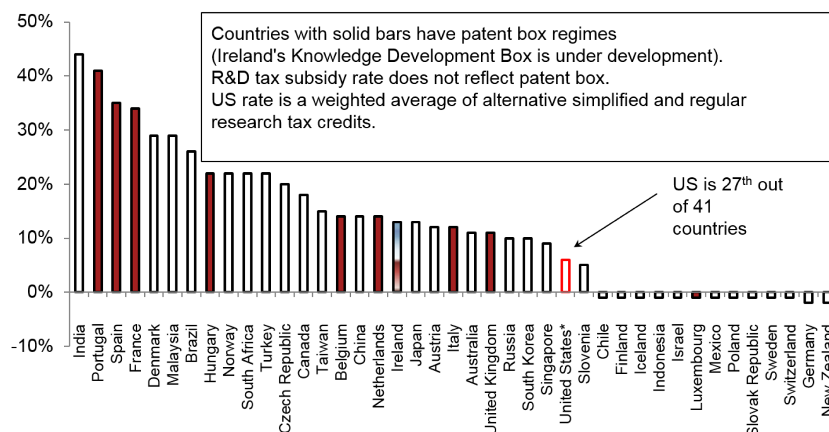
Evidence of the competitive disadvantage created by our international tax rules can be seen in the increase in foreign acquisitions of U.S. multinationals and in the number of cross-border merger and acquisitions in which the combined company has chosen to be headquartered outside the United States. The current system tilts the playing field against U.S. companies competing for acquisitions of foreign companies and U.S. companies with foreign operations. If the ultimate parent company were incorporated in the United States, distributions of foreign income to the ultimate parent company would be subject to the U.S. repatriation tax—a tax that would not apply (or could be mitigated) if the parent company were headquartered in a country with a territorial tax system. The tax system should create a level playing field that does not favor one owner over another. Our worldwide tax system essentially places a premium on the value of U.S. companies' assets in the hands of a foreign bidder.

If the United States were to adopt a territorial tax system similar to those adopted by most other OECD countries, U.S.-based companies would face the same effective tax rates in foreign markets as the foreign-based firms with which they compete. Eliminating the disadvantage U.S. companies face by aligning our rules with the rest of the world would be a far more effective response than ad hoc efforts to build higher walls around a U.S. worldwide tax system that places American companies and workers at a competitive disadvantage globally.

OTHER ELEMENTS OF A COMPETITIVE TAX SYSTEM

The U.S. tax system also lags behind many developed countries in other aspects that affect our global competitiveness. As shown in the chart below, the (expired) United States research credit is ranked 27th out of 41 countries in terms of the tax incentives provided for research and development activities.

RESEARCH CREDIT AND PATENT BOX REGIMES



In addition, an increasing number of countries are acting to provide "patent boxes" and related incentives for innovation, which also can be seen in the chart above.

Patent boxes have been considered as part of the harmful tax practices workstream in the OECD's BEPS action plan. The result of the debate is an agreement to permit patent boxes so long as they satisfy a nexus requirement that will link tax benefits to the performance of R&D activities. The nexus requirement thus may result in the relocation of R&D jobs from the U.S. to foreign countries to obtain the enhanced benefits.

As Dr. Laura Tyson noted in her recent testimony before this Committee, other countries "are using tax policy as a 'carrot' to attract the income and operations of U.S. companies with significant intangible assets and the positive externalities associated with them—including the spillover effects boosting innovation, productivity, and wages." [10] Two industries with particularly significant intangible assets and associated positive externalities are the technology and pharmaceutical sectors of the economy. Both industries are highly mobile and sell their products in global markets. The positive spillover effect on the local market noted by Dr. Tyson and other economists has led many governments to enact significant incentives for research-dependent operations in order to attract investment by technology and pharmaceutical companies. In the European Union in particular, many governments have concluded it is better to tax at a low rate the profits of these industries than to attempt to apply a higher tax rate and see these highly mobile activities leave the country to be performed in another location, costing the country tax revenue and the valuable jobs and spillover benefits that go with them.

The chart below details the patent box regimes available in the European Union.

EU Patent Box Regimes, 2015

Country	Standard Corporate Rate in 2015	Patent Box Rate in 2015	Fully Phased-In Patent Box Rate	Notes
Belgium	33.99%	6.8%	6.8%	80% patent income deduction
Cyprus	12.5%	2.5%	2.5%	80% exemption for income generated from owned IP or profit from sale of owned IP
France	38.0%	15.0%	15.0%	15% tax rate on royalty income

[10] Dr. Laura D'Andrea Tyson, U.S. Senate Committee on Finance hearing on "Tax Reform, Growth, and Efficiency," February 24, 2015.

EU Patent Box Regimes, 2015—Continued

Country	Standard Corporate Rate in 2015	Patent Box Rate in 2015	Fully Phased-In Patent Box Rate	Notes
Hungary	19.0%	9.5%	9.5%	50% deduction for royalty income from qualified patents
Ireland *	12.5%	n.a.	5.0% to 6.25%	The 2015 Irish budget proposes a "Knowledge Development Box." While the budget did not specify the reduced rate, it appears that a rate in the range of 5% to 6.25% may be under consideration.
Italy	27.5%	19.25%	13.75%	30% exemption for income derived from qualifying intangible assets. Exemption increases to 40% in 2016 and 50% in 2017 and beyond.
Luxembourg	29.22%	5.84%	5.84%	80% tax exemption of the net income deriving from the use and the right to use qualifying IP rights
Malta	35.0%	0.0%	0.0%	Full tax exemption for qualified IP income
Netherlands	25.0%	5.0%	5.0%	5% tax rate with respect to profits, including royalties, derived from a self-developed intangible asset
Portugal	29.5%	14.75%	14.75%	50% exemption for income derived from the sale or granting of the temporary use of industrial property rights (i.e. patents and industrial drawings and models)
Spain	28.0%	11.2%	10.0%	60% exemption for income derived from the licensing of qualifying IP rights. Corporate tax rate will fall to 25% in 2016.
United Kingdom **	20.0%	12.0%	10.0%	

* Proposed.
** UK standard corporate tax rate will be reduced from 21% to 20% effective April 1, 2015.

Dr. Tyson also noted the contrast between the carrot policies employed by other countries and the "stick" approach of the minimum tax proposal put forth in the Obama Administration's FY 2016 budget. As Dr. Tyson observed, the minimum tax approach would deprive U.S. companies, but not companies based elsewhere, of the tax benefits of patent box regimes.

THE CURRENT STATE OF U.S. INTERNATIONAL TAX RULES

To understand the disadvantage faced by U.S.-based companies in the global marketplace, it is useful to understand the operation of the current U.S. international tax rules.

Under the worldwide system of taxation, income earned abroad may be subject to tax in two countries—first in the country where the income is earned, and then in the taxpayer's country of residence. As noted above, the United States provides relief from this potential double taxation through the mechanism of a foreign tax credit under which the U.S. tax may be offset by tax imposed by the source country. The complexity of the foreign tax credit rules—income and expense allocations and other limitations—combined with the relatively high U.S. statutory rate limit their usefulness. As a result, even with foreign tax credits, U.S. companies often incur significant taxes when repatriating active foreign earnings. The added tax burden can make it more beneficial to reinvest foreign earnings abroad and accounts for the earnings of U.S. businesses designated as indefinitely reinvested abroad. For example, a U.S. company earning active income in the United Kingdom subject to the 20 percent UK rate would pay an additional 15 percent U.S. tax on that income if it were returned to the United States. As previously noted, the U.S. tax system should create a level playing field, not one biased against reinvesting profits in the United States.

In addition to complex foreign tax credit rules, the United States has unusually broad and complex rules that impose current tax on the active income of foreign affiliates, subjecting them to high U.S. tax rate on their foreign income even though the income remains abroad. As noted above, under U.S. international tax rules, foreign income of a foreign subsidiary generally is subject to U.S. tax only when such income is distributed to the U.S. parent in the form of a dividend. The subpart F exceptions to this rule impose current U.S. tax on certain income of foreign subsidiaries, and extend well beyond passive income to encompass certain active foreign business operations.

PROTECTING THE DOMESTIC TAX BASE

With the highest corporate tax rate among OECD countries, U.S.-based multinationals have a significant incentive to keep their foreign earnings abroad. The Obama Administration has cited reports that the amount of accumulated foreign earnings of U.S. companies exceeds $2 trillion. Although some of these earnings are in cash and liquid assets, a significant amount has been reinvested in expansion of the foreign operations of U.S. businesses to serve emerging markets.

A territorial system similar to those in other advanced economies would allow U.S. companies to invest their foreign earnings in the United States on the same basis as they invest them abroad and on the same basis as foreign companies invest in the United States. Rather than moving to territorial taxation, under which active foreign business income is taxed once at the foreign rate, the Obama Administration's recent budget proposal would impose immediate U.S. tax on foreign business income if the foreign effective tax rate is less than 22.4 percent. The difference between the stated minimum rate of 19 percent and the actual 22.4 percent rate is due to the fact that the minimum tax would apply to the extent 19 percent exceeds 85 percent of the foreign effective tax rate.

Imposition of a minimum tax of this scale and structure would put American companies at a competitive disadvantage in global markets, especially those that earn a large share of their income in global markets with effective rates below 22.4 percent. In Europe, for example, a significant share of the foreign income earned by subsidiaries of U.S. companies would be subject to the proposed minimum tax. Of 28 EU countries, more than half had statutory tax rates below 22.4 percent in 2014, and effective tax rates generally were lower.

Other developed countries with territorial systems have adopted a variety of anti-abuse rules to discourage income shifting without imposing a minimum tax rate. Those anti-abuse rules are aimed at preventing the erosion of the domestic tax base, not at imposing a global minimum tax rate that would handicap their globally engaged companies with operations in lower tax jurisdictions. The experience of other nations shows that safeguarding the domestic tax base need not entail disadvantaging domestic businesses in the global marketplace. Examples of anti-abuse rules employed by other countries include "thin cap" rules that limit excessive interest expense deductions and rules aimed at taxing foreign passive income on a current basis. Some countries have chosen not to extend territorial tax treatment to foreign affiliates in specific tax haven jurisdictions. But no other country imposes a minimum tax on active business income such as proposed by the Obama Administration.

The OECD BEPS action plan discussed below includes more stringent controlled foreign corporation (CFC) rules (like those of subpart F) and minimum taxes as one of the anti-base erosion items for study. In addition, the transfer pricing paper on action items 8, 9, and 10 includes a U.S. Treasury proposal regarding the minimum tax as a "special measure" to backstop transfer pricing rules. It is too soon to tell whether the OECD will embrace stronger CFC rules or the minimum tax, but public comments suggest that neither concept has been warmly received. If the United States were to enact a minimum tax while the rest of the world rejects the concept, it would push the United States even further from international norms to the disadvantage of U.S. companies and their employees.

In addition to the minimum tax proposal, the Obama Administration's recent budget includes proposed limitations on interest expense deductions that would significantly tighten the limitations of current law. Thin cap rules are also one of the items in the OECD BEPS action plan discussed below. As the Committee considers international reform, it will be important to consider the difference in rate between the United States and other countries. The value of deductions decreases as the tax rate is reduced. Thus a lower U.S. tax rate decreases the incentive to reduce U.S. taxable income, and in itself is a strong base protection measure. As a result, do-

mestic reform aimed at lowering the statutory tax rate complements reforms to modernize our international tax system. Limitations on interest deductions that go beyond international norms will further tilt the playing field against investment in the United States to the detriment of the American worker, a result that should be avoided.

IMPACT OF THE OECD'S BEPS PROJECT ON THE U.S. TREASURY AND TAX REFORM

The OECD's BEPS project, launched in 2012 by G–20 governments, including the United States, presents a challenge for the U.S. Treasury negotiators and for U.S. businesses and a threat to the U.S. tax base. As the Committee is aware, the BEPS project is intended to forge a global consensus on how to address base erosion and profit shifting. In July 2013, the OECD issued a 15-point BEPS Action Plan [11] that is scheduled to be completed by December 2015. Several reports have already been issued, and the OECD is on track to issue the plan's final reports this year. Although nominally a project aimed at a narrow problem—the erosion of governments' tax bases and profit shifting—the reality is that the 15-point action plan opens the door to rewriting the rules of international taxation in nearly every respect, and doing so in a period of two years. Therein lay both the challenge and the threat as the United States considers a long-overdue reform of our nation's tax laws.

There is no doubt that the international tax regime is in need of an update, nor is there any doubt that international consensus is critical with respect to the allocation of taxing rights on cross border income. There is no better organization to facilitate the discussion necessary to achieve that consensus than the OECD. However, OECD history shows that building consensus takes time. True consensus around a single solution chosen from an array of technically complex options has proven difficult to achieve even with ample time for consideration and debate. The rapid pace of the BEPS project, with discussion drafts being released and finalized quickly (sometimes with less than 30 days allowed for public comments) is in sharp contrast to the traditional approach of OECD consensus building. Moreover, it is clear from public statements and unilateral actions of the governments participating in the BEPS project that their positions diverge significantly, making even more challenging the efforts to harmonize their views.

The difference between source and residence countries provides one example of the divergent views and the challenge the negotiators face. At the inception of the project in February 2013, the OECD paper referred to the "balance between source and residence taxation" as an issue the project was intended to address, perhaps in deference to expectations of the developing countries that are part of the G–20 (but not the OECD) that BEPS would permit a discussion of the reallocation of taxing authority between source and residence countries. At the insistence of the United States, however, redrawing the line between source and residence was explicitly rejected in the BEPS action plan released in July 2013. While the explicit rejection was critically important, the allocation of taxing rights remains at the heart of many of the BEPS papers. Pandora's Box has been opened. The fact that redrawing the line is not part of the discussion has not diminished the participating governments' interest in doing so.

Given the reality of the fundamental rewrite of the international tax rules the BEPS project entails, failing to address divergent views head on means many issues hover beneath the surface unresolved. Even when there is basic agreement on issues, there can be disagreements over intent and meaning of words. In this case, the lack of resolution is likely to result in continuing intergovernmental disagreements once the ink has dried. Without agreement on clear rules, strains in resolving cross-border tax disputes—evident even before the BEPS Action Plan was initiated and reflected in the annual OECD report on mutual agreement procedure (MAP) statistics—are likely to increase.

While the BEPS project was intended to shore up the global consensus on the rules of international taxation, which was perceived to be unraveling, many governments have not waited for the BEPS process to play out and consensus rules to emerge. Harsh political rhetoric accompanying the effort has prompted some taxing authorities to seek an immediate increase in the tax paid by U.S. companies through audit adjustment. Others are using the BEPS project to advance a domestic tax agenda and to claim their "fair share" of corporate tax revenues. The risk inherent in this trend is that as soon as one country moves ahead of the OECD consensus

[11] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. *http://dx.doi.org/10.1787/9789264202719-en.*

process, others are spurred to action, not wanting to be left behind. As a result, the danger of "global tax chaos marked by the massive re-emergence of double taxation," of which the OECD Action Plan itself warned, may have markedly increased.

Even our close ally and proponent of the BEPS project, the United Kingdom, moved ahead of the project, proposing a "diverted profits tax" that is scheduled to take effect on April 1. Under this proposal, a 25 percent tax—5 percentage points higher than the UK corporate rate—would be imposed on profits that are considered to be artificially diverted from the United Kingdom. The proposed tests to determine whether this tax would apply are complex and subjective and appear to be aimed at U.S. companies. While the UK government is expected to release additional details on these proposals before the end of March, the basic structure of the UK diverted profits tax is likely to remain intact. The greater risk is that the UK approach may encourage other countries to propose similar policies affecting companies operating in their jurisdictions.

Issues regarding taxation of e-commerce were resolved in BEPS against a special set of rules for e-commerce. Just last month, however, a French government sponsored report [12] aimed at e-commerce recommended, among other things, the creation of a "sharing rule for corporate profits." The rule would reflect "the number of users in the jurisdiction of the tax authority." The report states that the existing taxation of multinationals "based on transfer pricing and territorial definitions" is obsolete. The report suggests the sharing rule should be developed as part of the existing OECD BEPS and EU initiatives, and cites a number of U.S.-headquartered multinational corporations as examples.

Additional countries, including Germany, Poland, Russia, Spain, Australia, Japan, India, Mexico, and Chile, have initiated unilateral actions since 2014 in advance of any formal consensus agreements under the OECD BEPS initiative. The French report highlights the risk of BEPS to the U.S. tax base. Although BEPS is aimed at base erosion and profit *shifting,* it would appear that some governments believe BEPS should provide for profit *sharing.* When governments look for the corporate profits of which they would like a share, the targets are usually U.S. companies.

This Committee has provided oversight to the BEPS project through a hearing in July of last year. Given that nothing is more fundamental to a nation's sovereignty than the right to tax, a point acknowledged by the OECD, it is important for the Committee to continue its oversight to assure that the OECD's historic goals of promoting economic growth and reducing regulatory burdens are given due consideration and not overrun by the unilateral actions of other countries in an effort to address concerns about base erosion and profit shifting. The extensive consultation with Congress involved in negotiating an international trade agreement should serve as a model in advance of any global effort to rewrite the international tax rules. As you noted during last year's hearing, Mr. Chairman, "we should not be rushed into accepting a bad deal just for sake of reaching an agreement."

CONCLUSION

The United States is operating in a global economy that increases both the competition American businesses and workers face and the opportunities available to them. At the annual Tax Council Policy Institute last month, Jon Moeller, CFO of Procter & Gamble, made the point that we cannot "pretend that if we don't have a competitive system it's going to be sustainably revenue-neutral." Since U.S. tax laws were last reformed, our international tax rules in particular have fallen behind other countries' efforts to attract investment and promote economic growth. In the absence of action by Congress to enact a more competitive U.S. international tax system, there will be an increase in the pace of U.S. companies being acquired by foreign competitors, and our current worldwide tax system will continue to effectively subsidize the treasuries of other countries seeking to tax U.S. multinationals. It is time for Congress to promote economic growth and enhance opportunities for the American people by enacting tax reform that, without increasing the deficit, reduces the U.S. corporate tax rate, broadens the tax base, and establishes a competitive international tax system.

---

[12] France Strategie, "Taxation and the digital economy: A survey of theoretical models," Final Report, February 26, 2015, *www.strategie.govr.fr.*

ARTICLE SUBMITTED BY HON. ROB PORTMAN

Financial Times, March 15, 2015

Tax Inversion Curb Turns Tables on US

By David Crow and James Fontanella-Khan in New York and Megan Murphy in Washington

A crackdown by the Obama administration on "tax inversion" deals, which allowed US companies to slash their tax bills, has had the perverse effect of prompting a sharp increase in foreign takeovers of American groups.

In September the US Treasury all but stamped out tax inversions, which enabled a US company to pay less tax by acquiring a rival from a jurisdiction with a lower corporate tax rate, such as Ireland or the UK, and moving the combined group's domicile to that country.

The move was designed to staunch an exodus of US companies and an erosion in tax revenues, but it has left many US groups vulnerable to foreign takeovers. Once a cross-border deal is complete, the combined company can generate big savings by adopting the overseas acquirer's lower tax rate.

Since the crackdown, there have been $156bn of inbound cross-border US deals announced, compared with $106bn in the same period last year and $81bn a year earlier, according to data from Thomson Reuters.

By far the biggest acquirers have come from countries with lower tax rates such as Canada and Ireland, which have announced $26bn and $22bn of deals respectively, highlighting the competitive advantage that their companies have when it comes to mergers and acquisitions. Before the crackdown, groups from Germany and Japan were the biggest buyers of US companies.

So far this year, foreign buyers have announced $61bn worth of US acquisitions, an increase of 31 per cent on last year and the strongest start to a year for inbound cross-border deals since 2007, according to the data.

When the Obama administration changed the rules governing tax inversions, many bankers and politicians warned it would not stop the exodus of companies from the US unless it was accompanied by a reduction in the headline rate of US corporation tax, which stands at 35 per cent. However, gridlock in Washington has made it very difficult to achieve a comprehensive overhaul of the tax code.

Senator Rob Portman, an Ohio Republican, said the jump in foreign takeovers since the crackdown "shows that one-off solutions instead of tax reform simply won't work. . . . The need for reform is urgent, and it's not a Republican or Democrat thing, it's non-partisan."

Investment bankers have been advising US clients—especially those in the pharmaceuticals and energy sectors—to seek foreign buyers so they can offer quick rewards to their investors via lower tax bills.

Furthermore, several American companies have built sizeable cash reserves outside the US in recent years, after they stopped the repatriation of overseas revenues to avoid being taxed at home. Being acquired by a foreign company would give them easy access to their cash piles.

However, George Bilicic, a vice-chairman of Investment Banking at Lazard, said there were other reasons for the jump in foreign takeovers. "Cross border M&A is being driven by US companies' desire to go global and non-US companies seeking to expand in America, which is enjoying a period of strong economic growth."

A Treasury spokesperson said: "The targeted anti-inversion action we took last year removed some of the economic benefits of inversions. But the only way to completely close the door on inversions is with anti-inversion legislation, and we have consistently called on Congress to act.

"As we've always said, we need to fix underlying problems in our tax code through business tax reform to address inversions and other creative tax avoidance techniques. We are committed to working with Congress to enact business tax reform that simplifies the tax code, closes unfair loopholes, broadens the base and levels the playing field."

PREPARED STATEMENT OF STEPHEN E. SHAY, PROFESSOR OF PRACTICE, HARVARD LAW SCHOOL, HARVARD UNIVERSITY

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is a pleasure to appear before you today to discuss the subject of how to build a competitive U.S. international tax system. I am a Professor of Practice at Harvard Law School. I practiced international tax law as a partner at Ropes & Gray for over 2 decades and have served twice in the Treasury Department—the first time in the Reagan Administration throughout the process leading to the Tax Reform Act of 1986 and the second time as Deputy Assistant Secretary for International Tax Affairs in the first term of the Obama Administration.

I. EXECUTIVE SUMMARY

The major points I would like to make follow:

- A competitive tax system is one that is able to fund effectively public goods, such as education, basic research, infrastructure, income security transfers and defense, which support a high standard of living for all Americans.
- The income tax is an important counterweight to increasing inequality in income and wealth in America. The Committee should focus on tax reform policies that preserve and increase the income tax base, including the corporate tax base, to be able to maintain a politically acceptable progressive rate structure.
- There is no normative policy justification for advantaging international business income of multinational corporations (MNCs) beyond allowing a credit for foreign income taxes. Evidence suggests that the U.S. taxes U.S. MNCs' foreign business income too little and not too much. The evidence does not support a claim that U.S. MNCs are non-competitive as a consequence of U.S. international tax rules.
- I recommend the Committee consider the following reforms to improve taxation of international business income. These reforms could be adopted as part of or independently of a broader business tax reform:
    - Adopt a minimum tax on U.S. MNCs foreign business income that is an advance payment against full U.S. tax when earnings are distributed from the foreign business.
    - Strengthen U.S. corporate residence and earnings stripping rules.
    - Reduce the U.S. tax advantages for portfolio investment in foreign stock over domestic stock.

II. BACKGROUND ASSUMPTIONS

The following are background assumptions that provide the context for the policies I recommend in this testimony.

- Even after taking account of recent spending limitations and revenue increases, the U.S. will continue to run a deficit, which is projected to expand in budget out years.
- Absent policy changes, the distribution of income and wealth in the U.S. will continue to shift toward the wealthy and the social and economic significance of income and wealth inequality will grow over time.
- Although global economic integration will continue, the global economy will expand as a result of increased population, investment and trade among the current actors (i.e., the emergence in recent decades of China, India and Brazil as major new economic participants will not be replicated). There will be further expansion of the reach and efficiency of wireless and electronic communications and increased reliance on the Internet as a means of commerce.
- The effects of globalization in eroding national tax systems (including income and consumption taxes) will continue, but how far and how fast, and whether international tax systems can respond in a mutually cooperative and beneficial way, is uncertain.
- The U.S. will continue to rely on the personal income tax for the largest portion of its revenue. The U.S. income tax system will continue to rely on a partially integrated corporate tax to protect the U.S. personal income tax base and to collect revenue from U.S. tax-exempt and foreign shareholders.
- Cross-border investment will continue to be dominated by MNCs and intercompany transfer pricing will be based on separate accounting.

III. POLICY BENCHMARKS

A competitive income tax system. A well-functioning U.S. tax system should provide revenue for the public goods that support high-wage jobs, innovation, produc-

tive investment, income security for those in need and personal security from domestic and international threats. A competitive income tax system would have a broad base and a progressive rate structure that retains public support through apportioning tax burdens according to ability to pay. A well-designed tax system should be capable of fulfilling revenue needs, including unforeseen needs of war or other emergency, through simple and transparent adjustments to tax rates.

We should stop using the tax system as a back door tool to regulate the size of government and to make non-transparent de facto public expenditures for specific industries or interest groups. In all but a few cases, spending and appropriation are the appropriate mechanisms to address these issues openly and transparently. The collateral damage to the most efficient revenue raising system in the world from its use as a political football has been substantial.

Role of the income tax. For over 100 years, the income tax has played a key role in developed countries in achieving a fairer distribution of the costs of public goods among national populations.[1] The central feature of an income tax is to measure individuals' worldwide income, from labor and capital, and to tax individuals based on their ability to pay measured by total income. The United States, which relies more heavily on the income tax to raise revenue than most other countries, taxes the worldwide income of U.S. resident individuals including imposing tax on worldwide income of domestic corporations. Taxing U.S. MNCs foreign business income is important to achieve the desired ability-to-pay objectives of the U.S. Federal income tax.[2]

Factual paradigms underlying international tax rules have changed. International tax rules were formulated in a time when it could be assumed that income from business carried on through a foreign subsidiary in another country where goods and services were sold (the source country) would be taxed at rates comparable to the rates in the country of residence of the MNC. It was customary to organize a foreign subsidiary in each country where business was conducted in a bilateral relationship between the MNC residence country and each source country where business was conducted.

The premise that a foreign subsidiary pays a tax comparable to a U.S. tax today is not just wrong, but very wrong for most U.S. MNC foreign subsidiary earnings. Based on 2006 tax return data, 45.9 percent (45.9%) of earnings of foreign subsidiaries that reported positive income and some foreign tax were taxed at a foreign effective rate of *less than* 10 percent (10%).[3] Such low foreign effective rates are not fully explained by lower foreign corporate tax rates in major U.S. trading partner countries, but also reflect ongoing MNC structuring to minimize tax by source and residence countries. Today, most international tax structures employ intermediary legal entities that do not bear a meaningful corporate tax because they are located in countries that facilitate very low effective tax rates on the income.[4]

---

[1] *See* Thomas Piketty, CAPITAL IN THE 21ST CENTURY, 498–502 (Harvard Belknap 2013) (emphasizing the role of economic shocks from the World Wars in adoption of high progressive rates).

[2] There is dispute among economists regarding the extent to which corporate tax is borne by shareholders or by labor. Nonetheless, the Staff of the Joint Committee on Taxation and the U.S. Treasury allocate over 75 percent (75%) of the burden of the U.S. corporate tax to shareholders. *See* Staff of Joint Comm. on Taxation, *Modeling the Distribution of Taxes on Business Income,* at 4–5, 30 (JCX 14–13; 2013). Based on Federal Reserve data, at the end of the third quarter of 2014, approximately 16 percent (16%) of the equity in U.S. corporations (not just U.S. MNCs) was reported as owned by foreign residents leaving 84% to be owned by U.S. residents. *See* Board of Governors of the Federal Reserve System, *Financial Accounts Guide,* Table L.213 Corporate Equities, available at *http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf.* Professor Sanchirico has questioned the ability to identify beneficial ownership of equities as a result of limitations in existing data sources and disclosures. *See* Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality,* 68 Tax L. Rev. (forthcoming). The issues Professor Sanchirico raises are important and the exact percentage of U.S. beneficial ownership of U.S. equities in fact is unclear. Moreover, even in the Federal Reserve data U.S. ownership has been trending slowly down in recent years, though it remains to be seen whether this will continue. Based on what we know, it nonetheless is likely that a fairly high percentage of shares in U.S. corporations is owned by U.S. residents.

[3] Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax,* 66 NAT. TAX J. 671, Table 3 at 699 (Sept. 2013). 53.9 percent (53.9%) of these foreign subsidiaries' income was taxed at a foreign effective rate of 15 percent (15%) or less and less than one quarter of these foreign subsidiaries' income was taxed at an effective foreign rate of 30 percent (30%) or more. *Id.*

[4] *See, e.g.,* Staff of Joint Comm. on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing,* at 122–127 (JCX 37–10; 2010) (in each of the six case studies, taxpayers use numerous intermediary legal entities to effect their tax avoidance strate-

The importance of taxing foreign business income. Taxing income earned abroad is necessary to prevent the simplest form of avoidance of U.S. residence taxing jurisdiction.[5] Aggregate and firm level financial data evidence substantial U.S. tax base erosion under current law.[6] As one firm level example, the staff of the Senate Permanent Subcommittee on Investigations found that Microsoft transferred rights to software developed in the United States to a subsidiary operating in Puerto Rico so that digital and physical copies could be made for sale to customers in the United States. In fiscal year 2011, Microsoft's Puerto Rican subsidiary booked over $4 billion of operating income for financial statement purposes and paid under 1 percent in tax (after paying $1.9 billion in cost sharing payments).[7] This income shifting from the United States is in the face of current transfer pricing regulations and Subpart F rules. As the Microsoft example demonstrates, one reason to tax foreign business income is to protect the U.S. tax base from erosion with respect to sales to U.S. customers.

There also is a need to protect the U.S. tax base in respect of sales to foreign customers. The pricing of U.S. intermediate goods and services with respect to sales to a foreign subsidiary, as well as the foreign subsidiary's non-U.S. sales, are subject to the same risk of U.S. tax base erosion. Even in cases where the foreign subsidiary is selling to another foreign subsidiary, a low level of tax on the income attracts profit-shifting investment because of the higher after-tax return and our transfer pricing rules are not capable of defending large effective tax rate differences. The combination of low-tax intermediary entities in countries enabling tax avoidance, transfer pricing and a range of other tax planning techniques are largely responsible for very low effective rates of tax on foreign income.

MNC competitiveness, lockout and dividend exemption. There is dispute whether U.S. MNCs are in fact tax disadvantaged under current law in relation to MNCs from other countries. The better case can be made that U.S. MNCs are advantaged, not disadvantaged.[8] It also has been argued that the large retentions of offshore earnings by U.S. MNCs' foreign subsidiaries are an important reason, if not the primary reason, to shift to a territorial tax system.[9] I respectfully disagree that the

---

gies); Leslie Wayne, Kelly Carr, Marina Walker Guevara, Mar Cabra & Michael Hudson, *Leaked Documents Expose Global Companies' Secret Tax Deals in Luxembourg,* INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Nov. 5, 2014, 4:00 PM), available at *http://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-globalcompanies-secret-tax-deals-luxembourg* (Luxembourg tax rulings for U.S. and non-U.S. MNE structures show multiple layers of companies).

[5] Daniel Shaviro, FIXING U.S. INTERNATIONAL TAX RULES 20–21 (Oxford 2014). Taxing worldwide income of U.S. citizens and residents has been upheld by the Supreme Court since the earliest days of the income tax. *Cook v. Tait,* 265 U.S. 47 (1924).

[6] *See* Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized,* 65 NAT'L TAX J. 247 (2012).

[7] *See* U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE, Exhibit 1, Memorandum from Chairman Carl Levin and Senator Tom Coburn to Subcommittee Members, *Offshore Profit Shifting and the Internal Revenue Code,* 20–22 (Sept. 20, 2012) (hereinafter cited as "Levin and Coburn, *Memorandum on Microsoft and HP*") at *http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code* (last visited May 30, 2013). The Puerto Rican subsidiary had 177 employees whose compensation averaged $44,000. Intangible rights with respect to the software lay behind the Puerto Rican operation's claim to 47% of the operating profit on the U.S. sales.

[8] *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption,* 59 EMORY L.J. 79, 85 (2009) (combination of deferral, defective source rules, foreign tax credits, weak transfer pricing and current use of branch losses give U.S. MNEs a net tax advantage over exemption country competitors); Edward D. Kleinbard, "'Competitiveness' Has Nothing to Do With It," 144 TAX NOTES 1055 (Sept. 1, 2014). The Administration's minimum tax proposal is estimated by Treasury to raise $206 billion over FY 2016–2025, but it would lose $103 billion from extending the active finance exception to Subpart F and other taxpayer favorable changes, for a net revenue gain of roughly $103 billion (before taking account of $268 billion from a one-time tax on pre-effective date earnings). The Camp proposal for a 95 percent (95%) dividend exemption was estimated to lose $212 billion for the period 2014–2023, but its Subpart F reforms would raise $116 billion over the same period for a net revenue loss of $96 billion over the period. With $170 billion of revenue from a one-time tax on pre-effective date earnings, however, the Camp proposal would levy in the budget period roughly $70 billion in additional tax on U.S. MNCs (compared with the Administration's roughly $371 billion). While there are questions about revenue effects beyond the budget period, these proposals arguably could be interpreted as representing an emerging consensus that U.S. MNCs should pay more tax on foreign income with the only remaining issues being how much more, how rules should be designed and what the revenue should be spent on.

[9] Republican Staff, Committee on Finance, United States Senate, TAX REFORM FOR 2015 AND BEYOND 254 (Dec. 2014).

evidence we have supports that conclusion.[10] Adverse effects of offshore retentions on U.S. economic activity are very unclear and do not lead to a conclusion we should relieve foreign business income from taxation. Offshore earnings retentions could as readily be addressed with full current taxation of foreign business income. The minimum tax proposal I outline below also would relieve some pressure on repatriating offshore earnings.

Foreign parent MNC's U.S. tax advantages. Foreign parent MNCs use debt and other earnings stripping techniques (that generally are not available to U.S. MNCs) to reduce U.S. tax on U.S. economic activity.[11] Indeed, this tax avoidance opportunity has encouraged U.S. MNCs to shift their corporate residence outside the United States.[12] A clear policy objective should be to neutralize a foreign parent MNC's advantage from using earnings stripping (which need not wait for passage of new legislation).

U.S. resident's foreign portfolio stock tax advantages. In addition to corporate tax reforms, it is important to re-examine individual shareholder level portfolio income taxation. If an objective is to protect the U.S. individual income tax base, U.S. individuals' portfolio investments in a foreign corporation should not be advantaged, as often is the case today, over a portfolio investment in a domestic corporation carrying on exactly the same global business. Today a U.S. individual portfolio shareholder in a foreign corporation bearing a low or no foreign corporate tax on foreign business income is more favorably taxed than the shareholder would be investing in the same business conducted through a domestic corporation. In a range of cases, this encourages individual and tax-exempt ownership of foreign rather than domestic equities and may indirectly contribute to shifting of corporate tax residence outside the United States. The taxation of dividends and gains from foreign portfolio equity investments should be reviewed and reformed under any of the international tax reform proposals.

IV. POLICY PROPOSALS

The preceding discussion leads me to recommend that the Committee consider the following proposals or areas for reform. Each of these ideas would address a current problem and would be helpful whether or not part of a more fundamental tax reform, but each also would work well as part of a broader reform.

Improve Taxation of Foreign Business Income

If the corporate rate were reduced materially, the first best choice would be to follow the Wyden-Coats proposal and tax foreign subsidiary earnings currently, in which case deductions allocable to foreign subsidiary earnings should be allowed in full.[13] I am skeptical that a lower corporate tax rate will be achieved in this Con-

[10] *See* Stephen E. Shay, *The Truthiness of "Lockout": A Review of What We Know,* 146 TAX NOTES 1493 (Mar. 16, 2015).

[11] *See* J. Clifton Fleming, Robert J. Peroni and Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework,* (forthcoming at 93 N.C. LAW REV. 101 (2015) (hereinafter "Fleming, Peroni and Shay, *Cross-Border Earnings Stripping*").

[12] Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations,* 144 TAX NOTES 473, 479 (2014); U.S. Treasury Dep't, EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 21–22 (2007); Willard B. Taylor, Letter to the Editor, *A Comment on Eric Solomon's Article on Corporate Inversions,* 137 TAX NOTES 105, 105 (2012).

[13] The Administration and Chairman Camp have each proposed a form of minimum tax combined with a form of dividend exemption. An important difference between the proposals from a revenue perspective is the Administration's limitation of interest deductions allocable to foreign subsidiary earnings eligible for a reduced rate of tax. The Administration and Camp proposals also vary in other important details but share the attribute of allowing foreign income to be exempt from U.S. tax so long as it is subject to an effective rate of tax that is less than the U.S. rate. The effects of the Administration minimum tax are not easy to discern without a specific proposal, including a specific corporate tax rate, particularly because the Administration proposal incorporates an allowance for corporate equity (ACE). Both the Camp and Administration proposals adopt design choices that, in quite different ways, directly or indirectly target MNCs that possess intangibles. My experience as a tax planner leads me to be skeptical of targeting income categories, such as intangibles, or adopting special relief provisions like the ACE, which experience in Belgium suggests can be difficult to design to achieve intended objectives. *See* Ernesto Zangari, *Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems* (Working Paper No. 44, European Commission Taxation Papers), available at *http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_44.pdf.* The U.S. experience with the Section 199 deduction for manufacturing activity provides another cautionary example of a misguided effort to target an ill-defined category. I suggest instead adopting a design for taxing foreign business income that is broader and does not exempt, as the Administration's ACE approach would, the primary layer of income from capital. With my co-authors Professors Fleming and Peroni, I have

gress, yet I think it is very important to address U.S. MNCs base erosion and profit shifting. Accordingly, I suggest as a second best approach an advance minimum tax on foreign business income that could be adopted today or as part of a broader reform.

Under an advance minimum tax, a United States shareholder in a controlled foreign corporation (CFC) would be required to include in income (under the Code's Subpart F rules) the portion of the CFC's earnings that would result in a residual U.S. tax sufficient to achieve the target minimum effective tax rate on the CFC's current year earnings. The target minimum effective tax rate would be based on a percentage of the of the U.S corporate rate, so that it would adapt to changes in the U.S. corporate tax rate.[14] Deductions incurred by U.S. affiliates allocable to the CFC's earnings only would be allowed to the extent the CFC's earnings were actually or deemed distributed. For example, if the actual and deemed distributions caused 35% of the CFC's earnings to be distributed, then 35% of the deductions allocable to the CFC's income would be allowed and the remaining 65% would be suspended until the remaining earnings were distributed.

The earnings deemed distributed would be treated as previously taxed as under current law and would be available for distribution without a further U.S. tax (which would reduce pressure on earnings held abroad). An advance minimum tax structured in this way could be readily adapted under the current infrastructure of U.S. international tax rules and could replace existing Subpart F income categories, including those for foreign base company sales and services income. This proposal could be implemented without waiting for a broader tax reform and without relying on a material reduction to the final corporate tax rate.[15]

Strengthen Corporate Residence and U.S. Source Taxation Rules

If taxation of foreign income is reformed, there will be greater pressure on U.S. corporations to change corporate residence. It is important to reconsider existing corporate residence rules beyond cases involving expatriating entities. The United States should consider broadening its definition of a resident corporation to provide that a foreign corporation would be U.S. tax resident if it satisfied either a shareholder residency test or the presently controlling place of incorporation test. I acknowledge that there currently are limitations on identifying ultimate owners of stock in publicly-traded companies, but identity of shareholders' or their tax residence already is used under the Code and it is feasible to increase the ability of corporations to learn shareholder identity information through reporting or other means. Importantly, linking corporate residence to greater than 50% control by U.S. tax residents would align corporate residence with the primary reason the U.S. seeks to impose a corporate tax which is to tax resident shareholders. There are important details to be worked out in designing a shareholder residence test, but I strongly encourage the Committee to pursue this avenue.

The first and most direct way to strengthen U.S. source taxation generally is through improved earnings stripping rules.[16] This has been the focus of the Treasury Department and I do not address details here except to emphasize that, unless addressed, U.S. MNCs will continue to attempt to shift corporate residence to take advantage of the U.S. tax reduction opportunities from earnings stripping.

Reduce U.S. Tax Advantages for Portfolio Investment in Foreign Over Domestic Stock

Under current U.S. tax law, a U.S. portfolio stock investor can earn a higher after-tax return on foreign business income earned through a foreign corporation

---

extensively critiqued a prior version of the Camp proposal and many of those observations remain relevant to the final proposal as well as to elements of the Administration proposal. Stephen E. Shay, J. Clifton Fleming, Jr. and Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi,* 141 TAX NOTES 173 (Oct. 14, 2013) (hereinafter Shay, Fleming and Peroni, *Territoriality in Search of Principles*).

[14] The Obama Administration proposal for a final minimum tax would apply if a foreign effective rate is less than 22.35 percent (22.35%). If the Obama Administration is seeking to achieve a 28 percent (28%) corporate tax rate, a minimum effective tax rate of 22.35 percent (22.35%) would be approximately 80 percent (80%) of the domestic corporate tax rate. If the corporate tax rate remained 35 percent (35%), however, the minimum effective tax rate would be approximately 64 percent (64%) of the domestic tax rate.

[15] I also would be very concerned if the Administration's minimum tax proposal were "cherry-picked" and, for example, the deduction disallowance rule were not adopted or the minimum tax rate were reduced by even a few percent. Maintaining a full residual U.S. tax mitigates the substantial tax base risks of such changes in the course of the legislative process.

[16] *See* Fleming, Peroni and Shay, *Cross-Border Earnings Stripping, supra* note 11.

than through a domestic corporation. In order not to favor a foreign corporation over a U.S. corporation in relation to foreign business income, at a minimum, foreign dividends should not qualify for a lower tax rate allowed for "qualified dividend income," or QDI, to the extent that the foreign corporate level effective tax rate is materially lower than the U.S. corporate tax rate.[17] In addition, the preferential capital gains rate (if retained) should be denied for stock gain attributable to the foreign corporation's non-U.S. earnings.[18]

A more fundamental alternative would be to determine the portfolio shareholder level U.S. tax on foreign earnings distributed from a foreign corporation in two parts. The first part would be a tax equal to the tax that would be paid on the foreign earnings if they were subject to domestic corporate tax including allowing foreign corporate-level taxes as a credit. This equalizing tax would be imposed on tax-exempt as well as taxable shareholders just as would occur in a domestic corporation. It is strange indeed to advantage investment by U.S. tax-exempts in foreign over U.S. corporations but that is the case today in relation to foreign corporations subject to low effective rates of tax.

The distributed earnings (reduced by that amount of tax as though it were a corporate-level tax), then would be subject to the normal U.S. tax rules for that dividend income.[19] The same mechanism could be applied to gains on the sale of foreign stock to the extent of untaxed deferred earnings.[20] This would mitigate the advantage to a U.S. portfolio shareholder of earning foreign income through a foreign corporation not subject to U.S. corporate level tax.

These modifications of shareholder taxation would bear on the corporate residence decision, particularly by domestic corporations that have a substantial U.S. shareholder base and may consider expatriation, not just in terms of the tax in connection with an expatriation, but in relation to ongoing shareholders. More generally, we need to scrutinize all of our international rules more closely to see where we may inadvertently be favoring non-U.S. over U.S. economic activity.

IV. CONCLUSION

International business income is but a part of the larger mosaic that comprises the U.S. economy. There is no normative reason to privilege foreign business income beyond allowing a credit for foreign income taxes. If any group of taxpayers does not bear its share of tax, others must make up the difference sooner or, if the deficit is debt-financed, later. The efforts of former Chairmen Camp and Baucus to lower tax rates in a revenue neutral tax reform illustrates the necessity of maintaining and expanding the tax base, including foreign business income of U.S. MNCs. Dynamic scoring will not alter this fundamental reality.

In no area of business are tax planning skills more acute and heavily deployed to take advantage of exceptions, special deductions and lower effective rates than in relation to earning cross-border business income. My recommendation is to tax foreign business income broadly and allow a credit for foreign income taxes. It al-

---

[17] *See* Shay, Fleming and Peroni, *Territoriality in Search of Principles, supra* note * [13], at 163–165; *see also* A.B.A. Tax Sec. Task Force on International Tax Reform, *Report of the Task Force on International Tax Reform,* 59 TAX LAW. 649, 698–699 (2006) (calling for reconsideration of the scope of QDI treatment for a dividend from a foreign corporation); *see also* Michael J. Graetz and Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation,* 113 COLUM. L. REV. 347, 361 (2013).

[18] In addition, with respect to corporate managers of expatriated companies, if foreign taxes are imposed at lower rates than U.S. taxes, Section 457A-type restrictions on compensation deferrals could be extended to all cases where the deferred amounts are not subject to a corporate tax equivalent to the U.S. corporate tax.

[19] The surrogate for a corporate level tax would apply to a U.S. portfolio shareholder that is a U.S. tax-exempt organization, just as a U.S. corporate level tax would apply in relation to earnings of a domestic corporation. The taxing structure described is used in current law I.R.C. § 962, which permits an individual U.S. shareholder in a CFC to elect to take a credit for a foreign corporate tax against the U.S. tax on a Subpart F inclusion, but conditions the election on (i) the shareholder being subject to a notional U.S. corporate level tax against which the foreign corporate tax is credited, and (ii) the shareholder being subject to normal U.S. tax when the earnings are actually distributed (though reduced by any additional tax paid under (i)). The Section 962 election is rarely used under current law. A U.S. portfolio shareholder owning less than 10 percent (10%) by voting power of the foreign corporation could be allowed to rely on the foreign corporation's published financial statements to make reasonable estimates of retained earnings and foreign taxes. In the absence of such information, gain would be attributed to earnings.

[20] A similar deemed corporate level tax is used as a limitation on the tax of an individual U.S. shareholder on dividend treatment of stock sale gain under Section 1248. See I.R.C. § 1248(b).

ways is possible to relieve a tax rule; it is very difficult in our system to make a tax rule tougher. I encourage you not to gamble with dividend exemption or an ACE deduction when there are more established and less risky ways to address the actual problems.

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

PREPARED STATEMENT OF ANTHONY SMITH, VICE PRESIDENT OF TAX AND TREASURER, THERMO FISHER SCIENTIFIC INC.

Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, it is an honor to appear before you today to discuss how this committee and the Senate can build a more competitive U.S. international tax system.

I am Tony Smith, Vice President of Tax and Treasury and Treasurer for Thermo Fisher Scientific Inc. Prior to joining the company over 10 years ago, I worked as a tax professional, beginning my career 25 years ago in the United Kingdom and focusing largely on U.K. tax matters. I then shifted my focus to U.S. tax matters in 1993 and moved here in 1998. My experience qualifies me to comment on U.S. and overseas tax regimes as well as company and shareholder reaction to tax rules and reforms. I have appreciated the opportunity to meet with many of your staffs over the past couple of years to discuss the pressing need for international tax reform.

I recognize that the committee is faced with difficult decisions and complex tradeoffs as you consider corporate, small business and personal tax reform that will result in an optimal tax system for the United States in today's global economy. My focus today is on corporate tax reform—with particular emphasis on international tax reform. I appreciate this opportunity to provide perspectives from the front lines on why international tax reform is so important to U.S.-based, globally engaged companies like Thermo Fisher. I'll also speak to the kinds of changes that I believe will make a real difference to the competitiveness of U.S.-based companies and their contributions to economic growth and jobs in the United States.

THERMO FISHER SCIENTIFIC'S BUSINESS

First, a little background on our company. Thermo Fisher Scientific is the world leader in serving science. Our mission is to enable our customers to make the world healthier, cleaner and safer, and we fulfill this mission by providing advanced technologies, products and services that help our customers address some of the most important challenges facing society today. For example, we have helped our customers screen for and contain the Ebola virus, discover better cancer treatments, monitor the environment to understand climate change and protect the safety of our citizens.

Thermo Fisher is headquartered in Massachusetts, but is a globally engaged company with 50,000 employees worldwide. Approximately half of that workforce is in the United States. We are proud to have major facilities in many of the states represented on this committee—including facilities in Logan, Utah, and Eugene, Oregon.

Our portfolio consists of some 1.3 million products, including analytical instruments used in research labs and production lines, specialty diagnostics that test for myriad health conditions, life sciences solutions to accelerate research, discovery and diagnosis, and a comprehensive offering of laboratory products and services.

Thermo Fisher's global revenue is approximately $17 billion. That revenue is split roughly 50/50 between the United States and overseas. We have a significant overseas customer base, and much of this revenue is derived from "Made in America" products that we sell to science customers around the world. These products come from not just Logan and Eugene, but also Lenexa, Austin, Asheville, Marietta, Allentown, Rochester, Kalamazoo, Fair Lawn, Rockville, Lafayette and Middletown, to name but a few.

Thermo Fisher's revenues have grown at an average rate of 10 percent per year since 2000. We continue to invest in technology innovation, commercial capabilities and emerging markets to grow our existing businesses. We have also acquired businesses to further strengthen our strategic position. In the last five years alone, we have spent more than $20 billion on acquisitions—both within and outside of the United States.

THERMO FISHER'S TAX PROFILE

Thermo Fisher manufactures a substantial volume of products in the United States. The company spends over $500 million per year in the United States on research and development to support new and existing products. The company benefits from the R&D tax credit when it is available. In 2014, the R&D tax credit was worth $25 million to Thermo Fisher. The company also benefits from the reduced effective corporate tax rate on domestic manufacturing under section 199, which was worth about $30 million to us last year. In addition, the company benefits from some timing items provided for in the current tax law, including use of the LIFO inventory valuation method.

Given our active acquisition history, Thermo Fisher has approximately $14 billion of debt. The company's interest expense is approximately $400 million per year.

In addition to our large U.S. manufacturing presence, Thermo Fisher manufactures products overseas in multiple jurisdictions, including China, Finland, Germany, Lithuania, Singapore, Sweden, Switzerland and the United Kingdom. We sell products in nearly every jurisdiction through both distribution affiliates and unrelated distributors. In all cases, the corporate tax rate imposed on profits earned in those jurisdictions is lower than the U.S. corporate tax rate.

Like many companies that have grown in part through acquisitions funded partly from U.S. sources and partly from overseas cash, Thermo Fisher has a complex overseas treasury and legal structure. Nearly all of the company's external debt is owed by U.S. members of the Thermo Fisher group to U.S. lenders. This is because it is optimal for a corporate group to issue debt through one face to the capital markets and because the capital markets in the United States are the most efficient in the world. The proceeds of this debt, along with funds generated from operations, are then used by our U.S. or overseas businesses to make acquisitions. While approximately half of the company's annual cash flow is generated overseas, Thermo Fisher currently has very little cash overseas. The vast majority of the cash from our overseas earnings is reinvested in the business or used for strategic acquisitions that increase our competitiveness and stimulate growth.

Some of Thermo Fisher's overseas income is subject to current tax in the United States under the Subpart F regime. This is because of the complex overseas treasury and legal structure just mentioned, which is a byproduct of the company's significant international growth via acquisition.

THE NEED FOR INTERNATIONAL TAX REFORM

The current U.S. international tax rules are unwieldy, subject to varying interpretation, and difficult to comply with. All of this gives rise to uncertainty for U.S.-based companies that are globally engaged.

Investors and companies want predictability and certainty. And the entire marketplace remains cautious as a result of questions about when—or if—Congress will reform the U.S. tax code. Recent inversion activity is a sign of frustration with an uncompetitive U.S. system and lack of confidence that reforms to make the system more competitive are imminent.

The combined effect of the high U.S. corporate tax rate and the U.S. worldwide tax system limits the flexibility of U.S.-based global companies to deploy the cash earned in their foreign businesses where it would be most productive. Given the high U.S. tax rate, U.S. multinationals will have overseas subsidiaries that make profits that are subject to taxes lower than in the United States. Most U.S. multinationals allow these earnings to remain overseas rather than face a large tax cost to repatriate the funds. If funds are needed in the United States, such companies borrow in the United States rather than access the earnings trapped overseas. Having a tax regime that creates a disincentive for U.S.-based companies to pay down debt—and indeed creates an incentive to incur new debt—is not sustainable in the longer term.

The current U.S. tax system also impedes the ability of U.S.-based global companies to undertake acquisitions that make good business sense and that would contribute to our domestic economy.

The existing tax rules can have the unintended effect of encouraging U.S.-based global companies to overpay for overseas acquisition targets because they have no other more productive use for the cash generated from their overseas operations. As a result, in pursuing non-U.S. acquisition targets, Thermo Fisher has been outbid several times by other U.S. multinationals that were willing to pay what we consid-

ered to be an above-market price for the foreign target. The other bidders had available cash from overseas operations and limited options for deploying this cash without incurring the prohibitive costs of repatriating funds to the United States; because of this, they were willing to pay a premium for the foreign target. Ultimately, this distortion of the acquisition market extends to similar targets in the same industry, because the excessive price paid sets an artificial new benchmark.

Conversely, the current tax system also places U.S.-based companies at a significant disadvantage when bidding against a foreign entity, regardless of where the target may be incorporated. Recent large acquisitions of U.S. targets by foreign acquirers have been valued more highly by the foreign buyers as compared to would-be U.S. buyers because their home country's tax laws allow them to structure transactions more efficiently and access the targets' global earnings without the home country tax that a U.S. buyer would face.

To restate: When it comes to M&A activity, the combined effect of the high U.S. corporate tax rate and the U.S. worldwide tax system means that:

- U.S. companies are more likely to be bought by foreign companies; and
- U.S. companies are more likely to overpay for foreign acquisitions.

Such a result—which is detrimental to the growth of U.S. companies—could not have been what the designers of the U.S. tax law intended. But this is the reality that currently exists.

Corporate inversion transactions are a related phenomenon. Notwithstanding the chilling effect of the notice issued by the Treasury Department last summer, the current U.S. tax system encourages inversion-type structuring in large M&A transactions. Like my example earlier, this can lead U.S. purchasers to overpay for target foreign companies. The market has seen the price for foreign targets being bid up simply because they are large enough for a U.S. company of the right size profile to invert into without a tax penalty. The long-term tax savings from inverting out of the United States can support the higher cost of the deal.

Finally, it is important to note that the U.S. tax system generally is more complex than foreign tax rules. Available R&D credits and other incentives are much lower in the United States than in many countries. And the U.S. R&D credit is rife with uncertainty due to its perpetually temporary and short-term nature. This encourages the development of high-value research centers, and the associated creation of high-value jobs, overseas where generous and stable incentives are available.

KEY ELEMENTS OF TAX REFORM

I commend the committee for its focus on tax reform in general and international tax reform in particular. I urge you to continue the effort to get much needed international tax reforms across the finish line as soon as possible. Such reforms are critical to the competitiveness of U.S.-based companies and to the continued strengthening of the U.S. economy.

Reforms should be designed to end the uncertainty that currently pervades the tax system for U.S. companies with global operations. Clearer and more stable rules would enable better investment decisions. I am convinced that many investment decisions are currently on hold while companies and investors wonder whether much-needed tax reforms will advance. This is a drag on the economy in the United States.

Tax reform should stimulate the U.S. economy, create jobs and strengthen the ability of U.S.-based global companies to succeed in an ever more competitive marketplace. And it should incentivize companies to make decisions—about mergers and acquisitions as well as general investment—based on total value rather than localized tax policies.

We should all recognize that other countries are taking measures to stimulate their own economies, including lowering their corporate tax rates and providing tax incentives, while the continuation of the high U.S. tax rate puts our future competitiveness at risk.

Finally, I want to be clear: Thermo Fisher recognizes that Congress needs to achieve a delicate balance in terms of revenue and understands that corporations may need to be prepared to cede certain long-standing tax benefits in the interests of improving the overall corporate tax system.

My suggestions for international tax reform are as follows:

1. Reduce the corporate tax rate:
   - A corporate tax rate between 25 percent and 30 percent would put the United States closer to other developed economies. There will continue to be lower rates in other countries, so this would not be any kind of a race to the bottom.
   - There will always be significant advantages to being headquartered in the United States. Therefore, it would not be necessary for the United States to match the world's lowest tax regimes. But we ought to lower the U.S. corporate tax rate to prevent the job leakage and other unintended consequences that arise with our current corporate tax rate that is out of line with the rest of the developed world.
2. Move closer to a territorial system by allowing repatriation of foreign earnings at a lower—but not zero—tax cost:
   - Repatriated overseas earnings should be taxed at a lower rate than the regular corporate rate. A U.S. tax on repatriated foreign earnings at a rate of 5 percent or slightly higher would not be a significant barrier to repatriation because most U.S.-based companies will value the flexibility to redeploy earnings in the United States rather than having to retain such earnings overseas.
   - This tax should be imposed when the earnings are repatriated to the United States.
3. Incentivize research in the United States:
   - Incentivize the development of intellectual property in the United States by making permanent the R&D credit.
   - Incentivize the utilization of intellectual property in the United States and generation of income here by a reduction in the rate of tax on earnings from that activity.
4. Simplify the Subpart F and foreign tax credit rules:
   - The existing rules are an administrative burden, over-complicated and too prone to different interpretations. Simplifying the rules could reduce the administrative burdens and uncertainties and better target the rules to their intended purpose.
5. Impose an appropriate limit on interest deductibility:
   - Consideration could be given to a limit on deductions for interest expense, based on an appropriate ratio of net interest expense to U.S. taxable income, with any surplus interest deductions being deferred. Today's historically low interest rate environment makes clear that any such limit would have to be based on a ratio that adjusts by being tied to prevailing interest rates. An appropriately structured limitation would encourage repatriation to pay down debt where the other reforms make such repatriation feasible from a cost perspective.
6. Avoid one-off tax incentives and holidays and reduce the number of cash-flow-only items:
   - In my opinion, LIFO inventory accounting and accelerated depreciation are timing items only and eliminating these benefits could be an acceptable trade-off for longer term permanent rate reduction and the other items mentioned here.
7. Continue to incentivize manufacturing activity and the generation of earnings in the United States through the reduced rate of tax on manufactured earnings under section 199.
8. Simplify reporting as much as possible.

These priorities echo themes that are reflected in tax reform proposals that have been proposed in recent years in the Senate and the House of Representatives and by the President. I believe the work that this committee and your colleagues in the House have already done provides a strong foundation for the development of a detailed tax reform package.

As I have emphasized throughout these comments, this committee's goal ought to be providing a more stable and more competitive environment for U.S.-based companies operating in today's global economy. This ultimate goal is more important than achieving the lowest possible corporate tax rate. But lowering the corporate tax rate

is an important element of competitive, pro-growth international tax reform. I stand ready to provide whatever assistance I can in this important initiative.

Thank you for the opportunity to present Thermo Fisher Scientific's perspective. I am happy to answer any questions that the committee may have.

PREPARED STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON

Nine months ago, the Finance Committee came together in this very room for a hearing on how the broken U.S. tax code hurts our competitiveness around the world—how it hinders the drive to create red, white, and blue jobs that pay strong middle-class wages.

The discussion was dominated by the wave of tax inversions that was cresting at the time, pounding our shores and eroding our tax base. Headline after headline last summer announced that American companies were putting themselves on the auction block for foreign competitors. They'd find a buyer, headquarter overseas, and shrink their tax bills to the lowest possible levels. In the absence of comprehensive tax reforms from Congress, the Treasury undertook extraordinary measures aimed at slowing the erosion.

Nine months later, the Finance Committee is back for another hearing on international taxation. And the headlines are back, too. Once again, there's a wave cresting—and this one's even bigger.

These days, it's foreign firms circling in the water and looking to feast on American competitors, often in hostile takeovers. And just like before, American taxpayers could be on the hook subsidizing these deals.

There's an obvious lesson here. Our tax code is deeply broken. The next flaw that exposes itself—the next wave that appears on the horizon—may not be about inversions or hostile takeovers. But whenever one wave breaks, you can bet there's another one rolling in, ready to pound our economy and erode our tax base further. The dealmakers will always get around piecemeal policy changes. Nothing short of comprehensive tax reform will end the cycle.

There's been an awful lot of ink spilled on business pages and in magazines about the many ways our tax code is outdated and anticompetitive. The corporate tax rate puts the U.S. at a disadvantage. The system of tax deferral blocks investment in the U.S. like a self-imposed embargo. How fitting it is on St. Patrick's Day to shine a spotlight on mind-numbing strategies like the "Double Irish with a Dutch Sandwich" used to winnow down tax bills.

A modern tax code should fight gamesmanship and bring down the corporate rate to make American businesses more competitive. That's what my own bipartisan proposal would do—in fact, it has the lowest rate of any proposal to date.

It's legislative malpractice to sit by and let this situation fester. Congress can't expect the Treasury to keep playing whack-a-mole with every issue that pops up. The latest wave of cross-border gamesmanship shows that cannot work. So the Finance Committee will need to lead the way on tax reform.

In my view, our end goals are bipartisan—a tax code that supercharges America's competitiveness in tough global markets, draws investment to the U.S. and creates high-skill, high-wage jobs in Oregon and across the country. It'll take a lot of work and political will to get there, but in the meantime, the waves will keep crashing and our tax base will keep eroding. So it should be clear to everybody what has to be done.

Thank you to all our witnesses for being here today—I'm looking forward to a fruitful discussion.

COMMUNICATION

THE LIFO COALITION
1325 G Street N.W., Suite 1000, Washington, DC 20005
TEL: 202–872–0885

March 31, 2015

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD–219
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

To The Finance Committee:

I am writing on behalf of the LIFO Coalition in response to testimony provided to the Committee at its March 17th hearing.

The LIFO Coalition (the Coalition), organized in April 2006, has more than 125 members including trade associations representing hundreds of thousands of American employers in the manufacturing, wholesale distribution, and retail sectors, as well as companies of every size and industry sector that use the LIFO method. A list of the LIFO Coalition members is enclosed.

The last-in, first-out (LIFO) method of inventory is used by a diverse array of American companies, including hundreds of thousands of pass-through businesses, to most accurately record inventories and measure income. Despite the widespread use of LIFO, LIFO repeal has been considered several times in recent years as a way to raise revenues to offset various spending initiatives or to pay for certain tax reform objectives.

An executive of a multi-national corporation testified before the Finance Committee on March 17th, at the Committee hearing on international tax. In his testimony, the executive made recommendations on tax reform, among them a suggestion that LIFO repeal "could be an acceptable trade-off for longer term permanent rate reduction. . . ."

LIFO Coalition members were both surprised and disturbed to read that testimony because for the overwhelming majority of LIFO users, a reduction in income tax rates would not in any way offset the repeal of LIFO. The situation facing pass-through companies on LIFO is even worse inasmuch as, based on the current debate, they could lose the use of LIFO without a reduction in the individual tax rates that they pay.

Because the testimony of this witness was so inconsistent with the position of the LIFO users who comprise the LIFO Coalition, the Coalition counsel reviewed the Form 10K filed by the executive's corporation to better understand its LIFO usage. Our review determined that less than 15 percent of the company's inventory is on LIFO, and that its LIFO reserve is very small.

With so little of its inventory on LIFO and such a small LIFO reserve, repeal of LIFO may well not be burdensome for this company. However, these are both unrepresentative statistics in comparison to most companies on LIFO.

To demonstrate that point, following the Finance Committee hearing, we quickly surveyed the members of the National Association of Wholesaler-Distributors (NAW) which are LIFO companies to determine the percentage of their inventories that are on LIFO. Of the 86 companies that responded to the survey, more than half (44 of

86) have 100 percent of their inventory on LIFO. And for more than 72 percent of the companies (62 of the 86), more than 70 percent of their inventory is on LIFO.

Further, a tax firm which specializes in LIFO systems advised the Coalition that, "of the hundreds of LIFO calculations we prepare annually for manufacturers, wholesalers and retailers . . . the vast majority, over 80%, use LIFO for *all* of their inventory."

This data and that of the NAW members is consistent with that of the diverse cross-section of industries that comprise the LIFO Coalition. The Coalition would be happy to substantiate that observation and provide additional data if the Committee requests that we do so.

The LIFO Coalition would ask the members of the Finance Committee to bear in mind the very different circumstances of the witness who testified that repeal of LIFO would be acceptable as they consider his recommendation on LIFO repeal.

For the overwhelming majority of the LIFO companies which have most or all of their inventory on LIFO and which have significant LIFO reserves, the repeal of LIFO is not only an unacceptable component of tax reform, it would both impose a punitive retroactive tax increase on them and force them to use an inventory accounting method prospectively that is totally inconsistent with their business models. For many of those companies, particularly thinly capitalized companies with small profit margins, repeal of LIFO would simply force them out of business.

The LIFO Coalition urges the Finance Committee to oppose LIFO repeal, as a separate measure or as part of a comprehensive tax reform effort.

Respectfully,

Jade West, Executive Secretariat
The LIFO Coalition

Enclosure

The Lifo Coalition

1325 G Street N.W., Suite 1000, Washington, DC 20005 TEL: 202–872–0885

Aeronautical Repair Station Association
Alabama Grocers Association
American Apparel & Footwear Association
American Chemistry Council
American Foundry Society
American Fuel & Petrochemical Manufacturers
American Gas Association
American International Automobile Dealers Association
American Iron & Steel Institute
American Petroleum Institute
American Road & Transportation Builders Association
American Supply Association
American Veterinary Distributors Association
American Watch Association
American Wholesale Marketers Association
Americans for Tax Reform
AMT—The Association for Manufacturing Technology
Associated Equipment Distributors
Association for High Technology Distribution
Association for Hose & Accessories Distribution
Association of Equipment Manufacturers
Auto Care Association
Automobile Dealers Association of Alabama
Brown Forman Corporation
Business Roundtable
Business Solutions Association

MDU Resources Group
Metals Service Center Institute
Mid-America Equipment Retailers Association
Midwest Equipment Dealers Association
Minnesota Grocers Association
Minnesota-South Dakota Equipment Dealers Association
Missouri Grocers Association
Missouri Retailers Association
Montana Equipment Dealers Association
Moss Adams LLP
NAMM-The International Music Products Association
National Association of Chemical Distributors
National Association of Convenience Stores
National Association of Electrical Distributors
National Association of Manufacturers
National Association of Shell Marketers
National Association of Sign Supply Distributors
National Association of Sporting Goods Wholesalers
National Association of Wholesaler-Distributors
National Automobile Dealers Association
National Beer Wholesalers Association
National Electrical Manufacturers Association
National Federation of Independent Business
National Grocers Association
National Lumber and Building Material Dealers Association
National Marine Manufacturers Association

The Lifo Coalition—Continued

1325 G Street N.W., Suite 1000, Washington, DC 20005 TEL: 202–872–0885

California Independent Grocers Association
Cardinal Health
Caterpillar Inc.
Ceramic Tile Distributors Association
Connecticut Food Association
Copper & Brass Fabricators Council
Copper & Brass Servicenter Association
Deep South Equipment Dealers Association
Deere & Company
East Central Ohio Food Dealers Association
Equipment Marketing & Distribution Association
Far West Equipment Dealers Association
Farm Equipment Manufacturers Association
Financial Executives International
Food Industry Alliance of New York State
Food Marketing Institute
Forging Industry Association
Gases and Welding Distributors Association
Greater Boston Chamber of Commerce
Health Industry Distributors Association
Healthcare Distribution Management Association
Heating, Airconditioning & Refrigeration Distributors International
Illinois Food Retailers Association
Independent Lubricant Manufacturers Association
Industrial Fasteners Institute
Industrial Supply Association
International Foodservice Distributors Association
International Franchise Association
International Sanitary Supply Association
International Sealing Distribution Association
International Wood Products Association
Iowa Grocers Industry Association
Iowa Nebraska Equipment Dealers Association
Jewelers of America
Kansas Food Dealers Association
Kentucky Association of Convenience Stores
Kentucky Grocers Association
Louisiana Retailers Association
Marine Retailers Association of the Americas
Maryland Retailers Association
McKesson Corporation
National Paper Trade Alliance
National Roofing Contractors Association
National RV Dealers Association
National Stone Sand & Gravel Association
Nebraska Grocery Industry Association
New Hampshire Grocers Association
New Jersey Food Council
North American Equipment Dealers Association
North American Wholesale Lumber Association
Ohio Equipment Distributors Association
Ohio Grocers Association
Ohio-Michigan Equipment Dealers Association
Paperboard Packaging Council
Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Power Transmission Distributors Association
Printing Industries of America
Professional Beauty Association
Retail Grocers Association of Greater Kansas City
Retail Industry Leaders Association
SBE Council
Security Hardware Distributors Association
Service Station Dealers of America and Allied Trades
Society of Independent Gasoline Marketers of America
SouthEastern Equipment Dealers Association
Southern Equipment Dealers Association
SouthWestern Association
Souvenir Wholesale Distributors Association
SPI: The Plastics Industry Trade Association
State Chamber of Oklahoma
Textile Care Allied Trades Association
Tire Industry Association
U.S. Chamber of Commerce
Washington Food Industry Association
Wholesale Florist & Florist Supplier Association
Wine & Spirits Wholesalers of America
Wine Institute
Wisconsin Grocers Association, Inc.
Wood Machinery Manufacturers of America