SUBMISSION TO

COMMITTEE ON WAYS AND MEANS

COMMENTS PRESENTED TO
THE INTERNATIONAL TAX REFORM WORKING GROUP

MARCH 11, 2013

THE FOLLOWING IS ATTRIBUTABLE TO

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March 11, 2013

The Honorable Devin Nunes
The Honorable Earl Blumenauer
Committee on Ways and Means
United States House of Representatives
Ways and Means Committee Office
1102 Longworth House Office Building
Washington D.C. 20515

Sent by email to: tax.reform@mail.house.gov

Dear Mr. Nunes and Mr. Blumenauer:

Re: International Tax Reform –
Why a Worldwide Full-Inclusion System Is
Far Better for our Country and Society
Than a Territorial System

I am commenting on the form that International Tax Reform should take. In brief, the Territorial System strongly lobbied for by the U.S.-based multinational corporations (MNCs) standing to benefit from such a system is not what's best for our country or our society. It is bad tax policy in today's environment where it is so easy for MNCs with their extensive resources to shift profits from the U.S. and into low-tax countries.

Rather than implementing a Territorial System such as that proposed in the October 26, 2011 Ways and Means Discussion Draft (W&MDD) or continuing our current Deferral System, our country, its people, and yes even our MNCs would best be served by implementing a Worldwide Full-Inclusion System (WFI System). Such a system would actually eliminate or severely curtail the strong motivation (even stronger under a Territorial System) that MNCs now have to shift profits out of the U.S. and into low-taxed countries, thereby achieving "double NON-taxation". Profit shifting motivation disappears when achieving double non-taxation is no longer possible because there's a current federal tax on all earnings and that tax cannot be eliminated through any tax schemes and creative avoidance.

So, this is what is needed: A taxation system that eliminates the present strong motivation to achieve double non-taxation through operating, owning assets, and bearing risks outside the U.S. These efforts, which shift profits and jobs out of the U.S., distort the business and investment decisions of our MNCs. International Tax Reform must put in place a new taxation system that will leave our MNCs free to make their business decisions based solely on business and investment factors such as location of raw materials and customers, employee wage rates, transportation costs, availability of qualified personnel, etc. Only the WFI System accomplishes this.

I am well aware that Chairman Camp and this Committee have significant time and effort invested in considering the Territorial System as the vehicle for International Tax Reform. Despite this, it must be clearly recognized that 99% of those who actually understand any of the theory and detailed practice of international taxation are paid by the MNCs that stand to directly benefit from a Territorial System. This means that before embarking on International Tax Reform, it is imperative that the Committee consider alternatives to the Territorial System, alternatives that take into account the interests of ALL Americans and not only the MNCs that are strenuously lobbying for this system.

Personal Background and Basis for Contributing to this Discussion

I was in private practice working for over 32 years in international taxation for several of the major international accounting firms. I now teach several international taxation courses within the Tax LLM program at the University of Washington School of Law. I consider myself to be an expert in the details of international tax planning, both from the domestic and foreign perspectives due to my having lived and worked outside the United States for more than half of my career.

Since retiring from private practice, I have taught international taxation for almost a decade as a member of academia. That role has supplemented my extensive practical knowledge of how our income tax laws work with a broader policy focus that takes into account a number of areas. These include the integrity of our country's tax base, competition and fairness, simplification, motivation to shift jobs and activities offshore, etc. In addition, I recognize how different taxation systems can encourage or discourage the profit-shifting behavior that has been such a major part of MNC tax planning over the past several decades…and about which we now see articles in the press almost daily.

Executive Summary

I define a WFI System as a taxation system under which all foreign earnings would be subject to the federal corporate income tax as they are earned. As such, there would be current U.S. taxation of MNC profits earned not only within U.S. group members, but also profits earned by group members established under foreign law. A foreign tax credit mechanism would prevent double taxation.

The chart on page 5 contrasts what would be achieved under the Territorial and WFI Systems. It is crystal clear on an overall basis that a WFI System will give America a better international taxation system. And it will actually broaden the tax base so that we can lower the current high corporate tax rate, something that both parties desire.

The single item that favors a Territorial System is competitiveness of U.S.-based MNCs versus their foreign-based counterparts. Aside from this single item, the WFI System uniformly provides significantly better societal and tax policy results for all listed issues.

Considering this single item, it is very understandable that the rallying cry of our MNCs lobbying for the U.S. to follow other developed countries that have adopted a Territorial System has been this competitiveness issue. Our MNCs demand a level playing field.

Is this a real issue, or is it just a red herring used to take attention away from the fact that a Territorial System would significantly reduce our country's corporate tax base by inappropriately benefiting one class of taxpayer over all others?

As is covered later in this letter, there will of course be specific situations where a U.S.-based MNC may be taxed more heavily than its foreign competitor. However, the relative competitiveness of these competitors in any particular situation will depend on a number of factors. These factors importantly include the nature of the business, the legal organization and structuring of each competitor, and the foreign competitor's home country and its controlled foreign corporation (CFC) rules. In some cases, a U.S.-based MNC could even be at a competitive advantage to one or more of its foreign competitors.

In summary, this one single item, while generally favoring a Territorial System over a WFI System, is not as clear-cut as our MNCs and their lobbyists would have us believe.

Now to a particularly important "competitiveness" point. In actuality, there are two categories of competition. One is the above-mentioned U.S. versus foreign competition that our MNCs have complained so much about and which I am suggesting may be a red herring to some extent. The other category is the relative competitive position between U.S.-based MNCs and U.S. corporations that operate solely within the U.S.

Under our present Deferral System, there are several very well-known, but not well-publicized, competitive advantages that U.S.-based MNCs have over pure domestic corporations. As just one simple example, an MNC can choose to manufacture in another country such as Singapore where there is a much lower tax rate, and maybe even a full tax holiday. On the other hand, a pure domestic corporation will manufacture in the U.S. and be subject currently to both the 35% federal tax and applicable state and local taxes.

We have to consider both types of "competition", not just the U.S. versus foreign category. And frankly, this writer believes that the second type, fairness and a level playing field between U.S.-based MNCs and pure domestic U.S. corporations that operate solely within the U.S., is the more important tax policy matter to "get right". The WFI System accomplishes this. The Territorial System worsens the MNC's advantage.

Chart Contrasting Territorial System and Worldwide Full-Inclusion System

Policy Issue	Territorial System	Worldwide Full-Inclusion System	System Best Accomplishing Policy Objective
Competitiveness Type 1—U.S. MNCs vs Foreign MNCs	A more level playing field but differences will persist due to varying CFC rules among countries	Competitive disadvantage for U.S. MNCs versus Foreign MNCs	Territorial System
Competitiveness Type 2—U.S. MNCs vs Pure U.S. Domestic Corporations	Advantages of U.S. MNCs over domestic corps increase further	More level playing field	Worldwide Full-Inclusion System
Neutrality (including the export of jobs)	Even stronger encouragement to move jobs and ownership of IP from the U.S. to overseas	Neutrality achieved	Worldwide Full-Inclusion System
Simplification	CFC rules and subjective areas like transfer pricing even more important due to exemption of foreign earnings	Real simplification through elimination of subpart F, etc. and of some problematic subjective areas	Worldwide Full-Inclusion System
Broadening the Tax Base (ability to generate tax revenues)	The participation exemption will lower the tax base, but this will be partly offset by stronger subpart F rules	True broadening of the tax base by making currently taxable all foreign earnings whether repatriated or not	Worldwide Full-Inclusion System This base broadening pays for corporate rate reduction
Encouragement of "Game Playing" to Shift Profits from U.S. to Low-Tax Countries	Even stronger encouragement than presently exists	Real reduction in "Game Playing"; motivation to shift profits eliminated or significantly curtailed	Worldwide Full-Inclusion System
Trapped Cash	Should solve but the proposed mechanism will cause this to be a continuing issue; changing the mechanism could solve this issue	Solved	Worldwide Full Inclusion System (and Territorial System if present mechanism is corrected)

One additional summary comment. If we enact a Territorial System, we must seriously strengthen our CFC rules (subpart F) and transfer pricing rules. This is because the "pot of gold" objective and motivation to achieve double non-taxation (earning income not taxed in any country) will be so much stronger under a Territorial System than it currently is under our Deferral System.

Frankly, if we enact a Territorial System, we're giving away the store and then putting in place simple patches or band-aids to keep the dyke from collapsing. And with the power of the MNC lobbyists, the chances are very low of there being any seriously strong patches or band-aids.

The point is that a Territorial System provides the strongest motivation possible for our MNCs to continue their legal tax avoidance and profit shifting. Our tax advisor community is well known for its century long tradition of creatively and legally bypassing or side-stepping CFC and transfer pricing rules. And it is very clear that the Internal Revenue Service (IRS) will have very limited resources to police the complicated structures and schemes that MNCs and their advisors will implement whatever new and enhanced CFC and transfer pricing rules are enacted to accompany a Territorial System.

So, which is the better system?

- A Territorial System that leaves in place strong motivation for tax avoidance and profit shifting, which the IRS can only challenge on a very slow resource intensive case-by-case basis, leaving many cases unchallenged due to the IRS's very limited resources, or

- A WFI System that would completely eliminate or severely curtail the motivation to conduct any tax avoidance or profit shifting by imposing a current home country tax that cannot be avoided or reduced except through its foreign tax credit mechanism.

The answer is very obvious. A WFI System will change our MNCs' collective behavior. A Territorial System will only make things worse.

This writer agrees that there are some economic arguments for a "sourced-based system" such as a Territorial System would provide. However, the current practical reality in our legal and tax environment is that our MNCs, with their Hippocratic Oath to maximize shareholder value (as well as their executives' equity-based bonuses), will work diligently with the tax advisor community to achieve tax avoidance and profit shifting goals. Any theoretical economic benefits of a source-based system are not worth the terrible tax policy aspects and future revenue losses that would accompany the adoption of a Territorial System.

Additional Issues Requiring Attention

The following are several issues requiring attention when considering a WFI System:

- Reduction of Corporate Tax Rate

  If a Territorial System were enacted, then our tax base would be significantly reduced. (Yes, this reduction will be offset to some extent by an expected expansion of subpart F and/or the tightening of the §482 transfer pricing rules, but given the strong MNC lobby and the few who actually understand anything about the economic effects of possible subpart F and §482 changes or the enforceability of such changes, the chances of serious expansion of these rules is minimal at best.) Because of this tax base reduction, keeping international tax reform revenue neutral will require significant cut backs on domestic tax expenditures such as accelerated depreciation, the domestic production incentive, etc.

  Adopting the Territorial System would be adding insult to injury: Not only do we increase the tax incentive to conduct operations, move jobs, and own assets outside the U.S., but we offset the cost of doing so by reducing incentives for operating and owning assets domestically. Considering this, it is simply ludicrous that we are even discussing the Territorial System at all.

  If a WFI System were enacted, then our tax base would be significantly increased. And this increased tax base provides a real basis for a reduction in our overall maximum corporate tax rate from its present 35% to some lower number.

  Such a reduced corporate tax rate would be beneficial not only to all U.S. corporations, but would be further encouragement for foreign companies to invest in and conduct business in the U.S.

  Finally, a reduced corporate tax rate is something both political parties support.

- Tightened Foreign Tax Credit (FTC) Mechanism

  Double non-taxation can be effectively achieved when an FTC mechanism liberally allows an MNC to "cross-credit" excess FTCs. This refers to the ability of an MNC to apply excess FTCs from one type of income or country against the U.S. corporate tax on other types of income or income earned in other countries where such income has been subjected to little or no foreign taxes. Where double non-taxation can be achieved, our MNCs will have strong motivation to continue profit shifting

  In order to prevent a continuation of profit shifting motivation, the foreign tax credit mechanism that would accompany the WFI System must be tightly drawn. By "tightly drawn", I mean a country-by-country or other foreign tax credit limitation mechanism that would severely limit the ability to cross-credit high foreign taxes paid on certain income against U.S. tax on low-taxed foreign income.

- Mechanism for Implementing a WFI System

  The Joint Committee on Taxation has considered several possible mechanisms for implementing a WFI System in "Present Law and Issues in U.S. Taxation of Cross-Border Income" (JCX-42-11, September 6, 2011). These mechanisms include:

  (i) Using the CFC subpart F rules,

  (ii) Applying a worldwide consolidation that includes all subsidiaries no matter where established, and

  (iii) Treating foreign subsidiaries as transparent vehicles.

  The Committee should analyze the alternatives and decide upon an approach.

  In reviewing possible mechanisms, the Committee should consider how to deal with situations where there is current taxable income from earnings within foreign subsidiaries but where the U.S. taxpayer has no access to the cash necessary to pay the tax. The Committee may identify situations where it is reasonable to defer the actual payment of U.S. tax until some future time or event. In such cases, the U.S. taxpayer should currently pay an interest charge to the U.S. Treasury on the deferred tax.

- Corporate Inversions

  A WFI System will further encourage corporate inversion and other transactions through which MNCs may attempt to escape U.S. taxation on foreign earnings. The Committee should consider whether the present anti-corporate inversion rules of §7874 are sufficient or whether strengthening amendments are needed.

- Certain Non-U.S. Corporations—Reconsider Definition of U.S. Residency and Treatment of Cross-Border Joint Ventures

  The federal tax system defines corporate tax residency on a place of incorporation basis. With the introduction of a WFI System, there will be an incentive for individual and other non-corporate investors in potentially global businesses to incorporate new ventures outside the U.S. In addition, where a U.S. investor (whether individual, partnership, corporation, etc.) holds an interest in a joint venture corporation established in a no or low-tax jurisdiction, the intended current taxation of a WFI System might be avoided.

The Committee will need to consider possible mechanisms to overcome available planning that would avoid the WFI System. Such mechanisms could include:

(i) A management and control corporate residency rule,

(ii) Expansion of the definition of U.S. shareholder within the subpart F CFC rules so as to include as U.S. shareholders those U.S. persons owning less than a 10% interest, and

(iii) An interest charge on earnings from certain foreign joint ventures (such as is applied under §1291 to passive foreign investment companies).

<u>Reducing Motivation to Shift Profits Out of U.S. and Benefits of WFI System</u>

Our U.S.-based MNCs are highly motivated to shift profit because they achieve <u>both</u> of two objectives:

- Reduction of tax imposed by the countries where actual business operations take place or where revenues from sales or services arise, and

- Avoidance of tax in the U.S. (easily achieved under our Deferral Systems through a decision to not repatriate earnings and through avoidance of the subpart F CFC rules from "check-the-box" or §954(c)(6) planning).

If either one of these objectives cannot be met, and especially the second objective concerning avoidance of U.S. taxation, then there will be much less motivation to go through the often significant effort necessary to plan and execute complex profit shifting strategies. This means that the current behavior of our MNCs will change if all of their international activities are subject on a current basis to a full U.S. corporate tax.

To achieve this current U.S. taxation and change MNC profit shifting behavior by eliminating the motivation for it, the U.S. should abandon its Deferral System and replace it with a WFI System. Doing this would mean that all foreign income, including profits in foreign subsidiaries, would be currently taxed at the regular U.S. corporate rates. A foreign tax credit mechanism would prevent double-taxation.

Benefits from adopting a WFI System include:

- An expansion and broadening of the U.S. tax base (in contrast to the Territorial System that would reduce the U.S. tax base)

- Eliminating the incentive to export operations, risks, tangible and intangible assets, and jobs out of the U.S. and into other countries (in contrast to the Territorial System that would make this incentive even stronger)

- Reducing or eliminating taxation as a factor in deciding where to conduct business operations, assume risks, employ personnel, and own tangible and intangible assets (in contrast to the Territorial System that would make taxation an even more important factor)

- Reducing the number of MNC profit-shifting structures that erode the U.S. tax base and require considerable IRS time and resources (in contrast to the Territorial System that would strongly encourage more MNC profit-shifting structures)

- Simplification of tax rules by eliminating the need for, or reducing the importance of, complicated subpart F CFC and transfer pricing rules (in contrast to the Territorial System that would make these complicated rules even more important)

- A more level competitive playing field within the U.S. among its pure domestic businesses, U.S.-based MNCs, and foreign-based MNCs operating in the U.S. (in contrast to the Territorial System that would make this playing field even more uneven)

- The potential for a reduced U.S. corporate tax rate due to its broadened tax base, thereby making the change to a WFI System more politically acceptable (in contrast to the Territorial System that would reduce the tax base and require higher domestic taxation for any change to be revenue neutral)

- A greater level of identity between publicly reported financial statement consolidated earnings and the federal taxable income computation (where there's identity between the two, management tends to be less interested in tax planning that reduces reported earnings as well as taxable income; by contrast, there would be no such identity under a Territorial System)

In addition to the MNCs that would directly benefit from reduced taxation under a Territorial System, some economists and academics find such a system attractive because of its source-based nature. I agree that source-based territorial systems do have some theoretical attraction. And it can also be said that residency is not a great theoretical basis on which to build a taxation system because the place of incorporation and management and control can often be easily manipulated by corporations and their owners. However, given the clearly demonstrated success of MNCs to transfer assets, risks and activities so as to shift jobs and profits out of the U.S. and into zero or low-tax countries, the continued use of the Deferral System or adoption of a Territorial System is irresponsible fiscally and bad tax policy from many perspectives. In short, use of either system is simply not tenable.

Background to Recommendations

Despite our Deferral System that in theory will eventually subject all overseas profits to federal taxation, many of our MNCs have succeeded dramatically in lowering their financial statement effective tax rates through achieving double non-taxation.

Our federal taxation system and bilateral tax treaty network work conscientiously to assure that U.S. taxpayers are not subjected to that dirty word: "Double Taxation". The U.S. accomplishes this through bilateral tax treaties that reduce foreign taxes and the FTC mechanism found in the Internal Revenue Code.

While our domestic taxation system and treaty network generally prevents double taxation, our highly motivated MNCs work hard to achieve "double non-taxation". This means no taxation in the countries where activities take place and revenues are earned and no taxation (or permanently deferred taxation) in the U.S.

There are many "environmental" factors that contribute to our MNCs' motivation and their high degree of success in achieving double non-taxation. These factors include:

- Acceptance by tax authorities and courts around the world of corporations and other legal entities, no matter where established and by whom owned, as separate and independent legal persons

- Ability of MNCs to contractually "break-up" their business activities by freely placing functions, assets and risks within both newly created member entities and existing member entities, all of which entities contract among themselves in any manner they please since the terms of such inter-company contracts will have absolutely no economic effect on the MNC group as a whole (aside from desired beneficial tax effects)

- Despite the inherent non-arm's length nature of these inter-company related-party contracts that have been structured to a large extent to achieve profit shifting and other taxation goals, acceptance internationally of such contracts as long as they reflect some degree of commercial reasonableness

- The arms' length standard in transfer pricing that by its nature causes some subjectivity in developing ranges of arguably acceptable pricing that spreads group profit among all the MNC group members

- The total discretion that our MNCs have to decide when, if ever, to repatriate through dividends paid to U.S. shareholders the profits earned by foreign subsidiary group members

- U.S. Generally Accepted Accounting Principles (GAAP) that allow our MNCs to lower their effective tax rate and increase reported earnings by accruing no future

U.S. federal income tax that would arise upon profit repatriation based on the MNC's intension to permanently reinvest those profits overseas

- Capital markets rewarding reductions in an MNC's effective tax rate and resulting higher reported earnings through higher share prices

- MNC management personnel being personally motivated to minimize effective tax rates due to equity-based compensation based wholly or in part on share price

All of these above factors are integral to our U.S. and worldwide legal, tax, and investment environment. As a practical matter, these factors cannot be changed.

The combination of these factors and our Deferral System creates an incredibly strong motivation for our MNC management teams to conduct operations, spread group risks and own group assets among the MNC group members in manners that shift profits out of the U.S. and other countries in which they conduct operations and earn revenue and into zero or low-taxed group members. Adoption of a Territorial System would only strengthen this profit-shifting motivation and desire for double non-taxation.

An alternative approach that actually reduces or eliminates MNC management's strong motivation for profit shifting is what's needed. The WFI System accomplishes this; other taxation systems continue or further strengthen this motivation. Any lesser approaches (e.g. tightening up transfer pricing rules concerning intangibles, stronger subpart F CFC rules, etc.) will only be "band-aids" easily side-stepped by our high-powered tax consulting community with its century-long tradition of working around anti-avoidance and other tax rules. These "band-aids" are all that would accompany the adoption of a Territorial System.

U.S. versus Foreign Competitiveness

I am sure that the Committee is aware of studies showing that the financial statement effective tax rates of U.S.-based MNCs compares favorably with those of non-U.S.-based MNCs. This favorable result for U.S.-based MNCs reflects:

- The success of U.S.-based MNCs in shifting profits out of both the U.S. and the medium to high-tax countries in which they operate or earn revenues (e.g. the U.K., France, Germany, Japan, China, etc.),

- Tax planning using the check-the-box rules and/or §954(c)(6) to avoid current U.S. taxation through subpart F income inclusions, and

- The U.S. GAAP financial statement accounting rules under which U.S.-based MNCs can effectively choose to avoid any accrual of future U.S. tax that would arise upon repatriation of foreign earnings, thereby allowing an effective tax rate that is far below the approximate 39% rate that should theoretically apply based on statutory rates (35% federal plus 4% state).

Considering these studies and the reasons behind these favorable results, it is clear that under our current Deferral System and under any Territorial System that might be enacted the evidence is questionable at best regarding whether there is any significant competitiveness issue.

We need to understand a little more about the competitiveness item labeled "Competitiveness Type 1—U.S. MNCs vs Foreign MNCs" in the chart on page 5 that contrasts what would be achieved under the Territorial and WFI Systems. In the chart, I stated the following:

- Territorial System—A more level playing field but differences will persist due to varying CFC rules among countries

- WFI System—Competitive disadvantage for U.S. MNCs versus Foreign MNCs

Some U.S.-based MNCs cry loudly proclaiming that MNCs based in other developed countries have no home country tax under their Territorial Systems. They say that this gives such MNCs a competitive advantage. While this can sometimes be true, there are seldom any details provided by those making these claims; the impression they give is that there are major competition issues that broadly apply to all our MNCs. In brief, we need to consider whether some details might help our understanding of the real situation.

Countries that maintain Territorial Systems must protect their own tax bases. Just as the Committee's 2011 W&MDD includes options for protection of the U.S. tax base, other countries have such protection mechanisms, one of the most important being CFC rules. Under such rules, an MNC's home country may apply the home country tax rate to some or all of the MNC's overseas income. Where this occurs, then a foreign competitor of a U.S.-based MNC would be in a similar economic position as the U.S.-based MNC would be under a WFI System.

A detailed review of other countries' CFC rules is beyond the scope of this comment letter. Despite this, something general can be said about this U.S. versus foreign competitiveness issue where the U.S. has a WFI System and the home country of the foreign competitor has a Territorial System. In brief, whether there is in fact any disadvantage at all to a U.S.-based MNC (or in some cases, even an advantage to such a U.S.-based MNC) will typically depend on the CFC rules imposed by the home countries of the foreign competitors. Some such countries tax the home-country parent currently on some active business income that has been subjected to relatively low local taxation.

To summarize and oversimplify a complex area:

- There will certainly be many cases where a foreign competitor has an advantage (e.g. the U.S.-based MNC under the WFI System is taxable at the normal U.S. corporate rate less a credit for any foreign taxes paid while the foreign competitor is free of any home country taxation and is taxed only in the countries where operations take place or where revenue is earned).

- There will be other cases where a foreign competitor's advantage is small, simply nonexistent, or even negative. This will occur where the foreign-based MNC's foreign income on a particular transaction or project is taxable in the home country under its CFC rules. This puts such a foreign-based MNC on a par with its U.S. competitor that is subjected to U.S. tax under a WFI System.

Interestingly, the Base Erosion and Profit Shifting (BEPS) Project of the Organisation for Economic Co-operation and Development (OECD) issued its first report recently on February 12th. The BEPS Project hopes to issue its second report early in the summer prior to the next G20 meeting and is expected to include in that report some suggested actions that countries could take to minimize corporate profit shifting. One area that may be suggested is strengthened CFC rules. If this occurs and other countries do strengthen their CFC rules causing more income to be subject to home country taxation, then there will be fewer instances of foreign-based MNCs holding a competitive advantage over U.S. based MNCs.

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I would be please to respond to any questions that you might have.

Yours very truly,

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