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Introduction & Overview

Good morning. Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, I want to thank you for the opportunity to testify this morning. I applaud your leadership in holding this timely hearing on the implications of tax reform on America's ability to attract foreign direct investment (FDI).

My name is Nancy McLernon and I am President and CEO of the Organization for International Investment (OFII). OFII is a business association exclusively comprised of the American subsidiaries of foreign domiciled companies. We advocate for fair and non-discriminatory treatment in U.S. law and regulation for these companies and the millions of hard-working Americans they employ. Our mission is to ensure that the United States remains the most attractive location for foreign investment and job creation for global companies looking to expand around the world.

This hearing comes at a time when the United States is at an economic crossroads, facing serious fiscal challenges at home and an increasingly competitive global landscape for attracting and retaining investment. As both the largest global investor and the largest beneficiary of inbound FDI, the United States plays a critical role in promoting open investment policies both domestically and abroad.

This Committee's work on fundamental tax reform is vital to ensure that the United States remains the premier location for global companies to invest. Simply put, America cannot afford to lose ground in the race for the world's investment.

The Economic Impact of Foreign Direct Investment in the United States

In spite of the historic success of the United States in attracting global investment, the extent to which it plays an integral role in U.S. economic strength and stability is not widely understood. The U.S. subsidiaries of global companies help to foster a diverse and vibrant American business community. Today, they employ over five million

American workers, maintain an annual payroll of over $400 billion, and account for six percent of private sector output – over 40 percent of which is concentrated in manufacturing. While they account for less than one percent of all U.S. businesses, the taxes paid by U.S. affiliates of foreign companies in fact account for 17 percent of corporate taxes collected. On top of tax payments, these companies reinvest billions of earnings back into their U.S. operations every year.

Foreign direct investment tends to disproportionately support a high-quality American workforce. U.S. subsidiaries pay their employees over 30 percent more than the average company, reflecting the high-skill nature of the scientific, engineering, and manufacturing jobs they create and sustain. In the hard-hit manufacturing sector alone, U.S. subsidiaries account for 13 percent of the labor force – over two million jobs.

Annually, foreign direct investment leads to over $40 billion in domestic research and development (R&D), accounting for more than 14 percent of America's private R&D investment. Many global companies choose to locate their global R&D headquarters in the United States in order to access a skilled workforce and favorable environment for innovation. This has tremendous benefits for the United States and is a factor that deserves careful consideration as part of tax reform.

Although counterintuitive to some, many globally based companies have established their American operations as a platform from which to manufacture goods to sell to the world. Their U.S. affiliates produce more than 18 percent of total U.S. exports – work that is helping our country reach the National Export Initiative goal of doubling exports by the year 2015.

As noted in a recent report by the President's Council of Economic Advisors, the vast majority of inbound investment originates from firms domiciled in other advanced economies. In 2010, almost 90 percent of inbound investment in this country came from Canada, Europe and Japan. In comparison, the report notes that only 2.1 percent of total inbound FDI originated from the rapidly growing economies of Brazil, China, and India combined.

It is also worth noting that, for all the headlines it generates, Chinese investment accounts for a miniscule portion – less than one percent – of foreign investment in the United States. And, according to the latest Department of Commerce statistics, the vast majority – 98 percent – of all foreign investment comes from the private sector.

The extensive benefits of inbound investment present a compelling case for open economic policies that encourage global companies to establish business here and boost America's economic growth.

<u>Dynamic Competitive Landscape</u>

In the midst of recent economic challenges, foreign investment continues to be an engine for job creation and a catalyst for growth and prosperity throughout the country.

As one example, at a time when the unemployment rate is a focus of national attention, Netherlands-based Philips Electronics is working to add 1,500 new jobs across the country. The company already employs over 25,000 people in United States, including over 1,000 at its manufacturing facility in Highland Heights, Ohio, where they develop, produce, and export high end medical-imaging technologies, such as MRI and CT scanners for customers around the world. Philips also chose to place the global headquarters of its healthcare division in Massachusetts and does the vast majority of its worldwide healthcare manufacturing work in the United States.

The competition to attract and retain companies like Philips has never been stronger. Companies today have an unprecedented array of options when looking to expand their business around the world. As a result, while America remains the largest recipient of the world's investment, its share is shrinking. A decade ago, the United States claimed more than 40 percent of cross-border capital but has seen its share shrink to less than half that amount today. In 2010, the United Nations Conference on Trade and Development (UNCTAD) found that, for the first time ever, developing economies claimed the majority of global FDI inflows – something that policymakers in the developed world would do well to keep in mind as they weigh the benefits of various economic and tax proposals. These changes are the result of a number of factors, but can in part be attributed to the aggressive efforts of other countries to attract and retain high-quality, job-creating investment from abroad.

<u>Recent Attention to FDI</u>

The Administration has taken steps in the last two weeks that suggest a growing understanding of the need to enhance American competitiveness to attract foreign investment.

Earlier this week, the President issued an investment policy statement that reaffirms our nation's long-standing commitment to open investment policies and recognizes the benefits of foreign direct investment in America's economy. This is the first such statement from a Democratic President in more than 30 years, and sends an important message to the international business community that America is committed to maintaining its leadership in promoting free and open markets at home and abroad. This action follows closely on the heels of an Executive Order signed last week to create a government-wide initiative entitled ***SelectUSA*** that will actively market the United States as a destination for foreign investment.

These developments help set the tone for a more favorable business environment for inbound investment, but must be followed by meaningful steps on core issues like tax reform, regulatory reform, and infrastructure investment if the United States is to remain competitive with the rest of the world for investment.

Tax Considerations

As American businesses, OFII's members share many of the same concerns regarding tax policy as other U.S. companies. OFII sees tax reform is an important opportunity to encourage greater foreign direct investment in the United States. In this regard, we believe Congress should give due consideration to two overriding factors in considering U.S. tax reform.

First, OFII is united with the broader American business community in its support for reducing the U.S. federal corporate income tax rate. Last year, OFII conducted a CFO survey on the investment decisions of global companies. Based on the results of the survey, we strongly believe that reducing the U.S. federal corporate income tax rate will significantly increase investment in the United States, which will lead to further job growth.

Second, in pursuing tax reform, OFII encourages increasing the certainty, transparency, and reliability of the U.S. tax system in a manner that is not discriminatory against the U.S. subsidiaries of foreign business enterprises that invest in America. Such an approach will similarly lead to increased U.S. investment and job creation. I would like to take this opportunity to discuss a few areas in the tax law that provide opportunities for improving the attractiveness of the United States as a location for investment by removing impediments to foreign investment in the United States.

<u>Section 163(j)</u>

One of the most burdensome U.S. tax limitations imposed on U.S. subsidiaries is section 163(j). These rules, originally enacted in 1989, disallow current deductions for certain interest paid by domestic corporations to foreign related parties and tax-exempt entities. This limitation is imposed to the extent the debt-to-equity ratio of the corporation exceeds 1.5 to 1, and the corporation's net interest expense exceeds 50 percent of the domestic corporation's adjusted taxable income. These rules were expanded in 1993 to apply to interest paid by domestic corporations to unrelated parties and guaranteed by a foreign related party.

The current section 163(j) rules are overly broad, have a discriminatory impact on U.S. subsidiaries, and serve to reduce investment in the United States. Section 163(j) principally impacts U.S. subsidiaries of foreign-owned corporations. OFII has had longstanding objections to these rules because they discriminate against foreign-owned U.S. companies. In addition, they violate the U.S. commitment in our tax treaties to not impose discriminatory taxation. The nondiscrimination article of virtually all U.S. income tax treaties commits the United States to permit U.S. companies a deduction for interest paid to a treaty-partner resident to the same extent that it would be allowed for interest paid to a U.S. resident. This is a mutual commitment, meaning that the treaty partner commits to the same obligation to avoid discriminatory tax treatment of U.S. residents investing in the treaty partner's jurisdiction.

There are valid business reasons for funding a U.S. subsidiary with debt. In many cases, the ability of a foreign multinational to finance its U.S. subsidiaries' operations in an economically viable manner requires using a degree of debt financing. However, because the U.S. subsidiary on a stand-alone basis often lacks the high credit rating that would allow the U.S. subsidiary to borrow from unrelated parties at competitive interest rates, the only way the U.S. subsidiary can obtain low-cost debt capital is by borrowing from its foreign parent company (or another affiliate that acts as the financing arm of the corporate group), which in turn can more efficiently borrow from the worldwide credit markets. Alternatively, the U.S. subsidiary can borrow from unrelated parties with a foreign parent guarantee in order to reduce the amount of interest otherwise payable on the debt.

Tightening section 163(j) would increase the cost of capital for U.S. subsidiaries, thereby reducing the after-tax return on investment that they earn from their U.S. operations. This would likely result in lower levels of investment in the United States. As the Joint Committee on Taxation has recently stated, "the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as [proposals to tighten section 163(j)]."

There have been proposals in recent years to further restrict current law interest deductions under 163(j), primarily for related party debt, but none of those proposals were based on economic data or statistics demonstrating that further restrictions were justified. OFII believes that any further changes to section 163(j) should not be adverse. In fact, similar to legislation passed in the Senate in 2004, consideration should be given to eliminating the application of section 163(j) to guaranteed debt, particularly where the interest is subject to U.S. net income tax by the unrelated U.S. third party.

In its 2007 report on earnings stripping, the Treasury Department found no conclusive evidence of earnings stripping by U.S. subsidiaries. The U.S. tax law has robust statutory and common law tools that require taxpayers to employ only an appropriate amount of related party debt financing and on terms that are comparable to what would be agreed on an arm's length basis with unrelated parties. In order for interest to be deductible, the taxpayer must establish that it was paid in respect of a bona fide debt, which is determined under a broad set of common law standards. These standards are vigorously enforced by the IRS and are applied as a threshold matter before the mechanical and arbitrary limitation rules under current law section 163(j). Any further adverse extension of these discriminatory and arbitrary rules of section 163(j) would further amplify the discriminatory impact on U.S. subsidiaries, and further reduce the levels of investment in the United States that might otherwise be available to enhance job creation.

Tax Treaties

In pursuing tax reform, respect for our obligations under U.S. income tax treaties should be of paramount importance. Income tax treaties play a fundamental role in U.S. international tax policy. A basic purpose of tax treaties is the promotion of bilateral trade and investment, to the benefit of both U.S. and foreign multinational corporations and the global economy. Treaties reconcile the independently developed tax laws of treaty partners in order to avoid double taxation and excessive taxation of cross-border income. In that way, tax treaties remove artificial barriers to bilateral trade and investment. Treaties also include a commitment made by both countries to avoid discriminatory tax treatment of residents of the other country, a commitment that has been a bedrock treaty policy of the United States almost from the beginning of the U.S. tax treaty program.

Virtually all multinational enterprises with operations in countries with which the United States has a treaty rely on our tax treaties to provide greater objectivity, clarity, and certainty in how cross-border transactions will be taxed by the treaty partners and also rely on treaties for the ability to avoid potential double taxation where there are disputes. In addition, treaties provide important tools to the tax administrations of the treaty partners for policing cross-border activities through the exchange of information and cooperation in enforcement of the tax laws.

Tax treaties provide greater certainty and clarity to foreign taxpayers investing in the United States regarding their potential U.S. tax liability but only if the treaties' provisions are respected. Our treaties reflect the results of good faith bargaining whereby each country agrees to concessions in exchange for the greater benefits that result from the treaty relationship. Changes in the U.S. tax laws should not override, or conflict with, our existing U.S. tax treaty obligations. Such actions result in less certainty and confidence in our tax rules and, thus, can lead to reduced investment in the United States. Such adverse changes in law also send a message to our treaty partners that they cannot rely on the mutual concessions made in the treaty.

In addition, as the 2007 Treasury Department report on treaties indicates, the Treasury Department has effectively policed perceived tax abuses by insisting that new treaties contain robust anti-treaty shopping rules, reflected in the Limitation on Benefits article of treaties, and by renegotiating our existing income tax treaties to include LOB provisions in line with current U.S. anti-treaty shopping standards. These provisions ensure that the treaties are used by appropriate parties. Most U.S. income tax treaties contain an LOB provision, and the Treasury Department has diligently worked to renegotiate existing treaties that lack a robust LOB article to include such an article where those treaties may be susceptible to inappropriate use by residents of third countries. Recent examples include the income tax treaties with Iceland (in force), Hungary (near ratification), and Poland (near completion).

Consistent with the Administration's efforts, the strengthening of the U.S. tax treaty network in this manner is the appropriate path to address perceived abuses, rather than through domestic tax law changes that can override, or conflict with, the treaty's provisions, including possible violation of the non-discrimination rules that the U.S. insists be a part of every treaty. Recent examples of some of these concerns include proposals to override tax treaties with respect to deductible payments to affiliated entities that qualify for treaty rates, and proposals to tax foreign corporations as U.S. corporations if they are primarily managed in the United States.

Importantly, treaty overrides are not limited to federal legislation. In certain cases, individual States have effectively overridden the provisions of U.S. tax treaties (*e.g.*, State rules that "add back" certain income for State tax purposes or mandate the inclusion of certain foreign entities in a state tax filing, where such income or entity is otherwise entitled to benefits under U.S. federal income tax treaties). This increasing trend by States is of great concern to OFII members and to the governments of their respective home countries and is an impediment to investment in the U.S. OFII would be happy to discuss further ways to enhance the certainty of the U.S. tax treaty network in order to increase U.S. investment in a manner consistent with the important tax treaty principles discussed above, including non-discrimination provisions that the United States has consistently advocated throughout the life of our tax treaty program.

Transfer Pricing

The U.S. transfer pricing rules, which are contained in section 482 of the tax code and the regulations thereunder, apply for purposes of determining the appropriate prices of goods, services, and intangible property transferred between related companies. These rules are intended to achieve the internationally accepted arm's length standard. These principles are also reflected in our U.S. income tax treaties, which seek to resolve cases of double taxation involving more than one taxing jurisdiction. Current transfer pricing rules have resulted in substantial complexity and uncertainty in their application to our members.

OFII commends the efforts that have been made to date to reduce uncertainty in this area, including reducing administrative burdens in certain cases associated with complying with the transfer pricing rules, as well as increasing the ability to determine in advance appropriate transfer pricing methodologies under the IRS' Advanced Pricing Agreement program (both unilaterally and bilaterally with our treaty partners) and fully supports adding additional resources to these programs. OFII also commends the efforts to include in more U.S. income tax treaties binding arbitration provisions that seek to resolve in a timelier manner transfer pricing disputes between treaty countries' taxing authorities. OFII looks forward to working with the Congress and the Administration on additional ways to increase certainty in this area.

I am pleased to answer any questions you may have, and look forward to working with this Committee and the Congress in considering tax reform that will increase investment in the United States.