

Submission to the House Ways and Means Committee Hearing  
On Transfer Pricing Issues, July 22, 2010  
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I began my career as a field attorney for the IRS Office of Chief Counsel working on, among other things, large case transfer pricing matters. For the past 20 years I have been a corporate international tax attorney working for both American and foreign-owned companies. I am offering this submission in my capacity as the Director of SharedEconomicGrowth.org, an organization devoted to reviving the American economy through sensible, revenue-neutral and progressive tax policy reforms.

The Internal Revenue Service has long had the resources and the power necessary to vigorously enforce appropriate transfer pricing. They have the power to obtain any non-privileged information held by any subsidiary of an American corporation around the world, and to interview any employee or executive. They have the right to look back to see if apparent misrepresentations were made about the value of transferred technology. They have senior agents and competent economists assigned permanently to every major U.S. corporation. The fact that this committee still has concerns about transfer pricing suggests that the cure must lie with a new approach.

The Administration has suggested that high margin profits from foreign operations be taxed currently at high rates. This ignores the fact that American companies compete with foreign rivals who are free to establish operations in low tax locations. These rivals could crush or buy out their American counterparts if our companies are denied the same privilege. America is no longer invulnerable to competition.

However, all of the concerns raised at this hearing would be eliminated – and indeed turned around to the benefit of the United States – if we instead implemented a practical, revenue-neutral reform that would make the United States the most desirable location in the world in which to place high-technology, high-margin operations, the kinds of operations that produce the jobs that we want Americans to have. Clearly, we cannot currently afford to gamble on throwing out our current tax system and trying something fundamentally new. However, it is not necessary to do anything that radical. We can keep our current system while enacting a simple, three page bill that would cause corporations to want their high value operations to be here. This would maintain and strengthen the government's revenue base, replacing the complex issues discussed here today with clean, easy-to-tax dividend income.

All of this could be done with the Shared Economic Growth bill set forth and explained in the attachment. I recommend it to the Committee's attention. At the end of the day, it is the only solution that will really work.

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## **A Bill**

To amend the Internal Revenue Code of 1986 to remove incentives to shift employment abroad, and to remove hidden taxes on retirement savings and provide equitable taxation of earnings.

### **SECTION 1: SHORT TITLE**

This Act may be cited as the "Shared Economic Growth Act of 2010".

### **SECTION 2: PROVIDING INCENTIVES TO LOCATE HIGH-VALUE JOBS IN AMERICA AND TO INJECT CASH INTO THE AMERICAN ECONOMY**

(a) Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new section:

"251. (a) General Rule. In the case of a corporation, there shall be allowed as a deduction an amount equal to the amount paid as dividends in a taxable year of the corporation beginning on or after January 1, 2011.

(b) Limitation of benefit to tax otherwise payable.

- 1) The deduction under this section may not exceed the corporation's taxable income (as computed before the deduction allowed under this section) for the taxable year in which the dividend is paid, decreased by an amount equal to 2.85 times any tax credits allowed to the corporation in the taxable year.
- 2) Where the deduction otherwise allowable under this section in a taxable year exceeds the limitation provided in paragraph 1 of this subsection, the excess may be carried back and taken as a deduction in the two prior taxable years or forward to each of the 20 taxable years following the year in which the dividends were paid. However, the total deduction under this section for dividends paid during the taxable year plus carryovers from other taxable years may not exceed the limit provided in paragraph 1 of this subsection. Rules equivalent to those provided in paragraphs 2 and 3 of subsection 172(b) of this subchapter shall govern the application of such carryover deductions.
- 3) No amount carried back under paragraph 2 of this subsection may be claimed as a deduction in any taxable year beginning on or before December 31, 2010. c) Consolidated groups. In the case of a group electing to file a consolidated return under section 1501 of this Subtitle, the deduction provided under this section may be claimed only with respect to dividends paid by the parent corporation of such consolidated group."

(b) Subparagraph (b)(1)(A) of Section 243 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(A) if the payor of such dividend is not entitled to receive a dividends paid deduction for any amount of such dividend under section 251 of this Part, and if at the close of the day on which such dividend is received, such corporation is a member of the same affiliated group as the corporation distributing such dividend, and”.

(c) Section 244 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years beginning after December 31, 2010.

(d) Subparagraph (a)(3)(A) of Section 245 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(A) the post-1986 undistributed U.S. earnings, excluding any amount for which the distributing corporation or any corporation that paid dividends, directly or indirectly, to the distributing corporation was entitled to receive a deduction under section 251 of this Part, bears to”.

(e) Subsection 1(h) of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years ending after December 31, 2010.

(f) Subsection (a) of Section 901 of Part III of Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. However, in the case of a corporation, no credit shall be allowed under this section or under section 902 for foreign taxes paid or accrued, or deemed to have been paid or accrued, in tax years beginning after December 31, 2010. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).”

This amendment shall override any contrary provision in any existing income tax convention.

### **SECTION 3: PREVENTING WINDFALL BENEFITS FOR FOREIGN INVESTORS**

(a) Section 1441 of Subchapter A of Chapter 3 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding at the end of subsection (a) thereof:

“, and except that in the case of dividends, the tax shall be equal to 35 percent of such item.”

The imposition of this 35 percent withholding tax on dividends shall override any contrary restriction in any existing income tax convention.

(b) Section 1442 of Subchapter A of Chapter 3 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding at the end of the first sentence of subsection (a) thereof:

“, except that in the case of dividends, the tax shall be equal to 35 percent of such item.”

The imposition of this 35 percent withholding tax on dividends shall override any contrary restriction in any existing income tax convention, except that any treaty limiting the imposition of U.S. tax on dividends paid from a U.S. resident corporation to a foreign parent corporation shall not be overridden where the foreign parent owns, directly or indirectly, at least 80 percent of the voting stock of the U.S. corporation and where the foreign parent is 100 percent owned, directly or indirectly, by a corporation whose ordinary common shares possessing at least 51 percent of the aggregate voting power in the corporation are regularly traded on one or more recognized stock exchanges.

### **SECTION 4: FAIR FUNDING FOR RETIREMENT SECURITY**

(a) Section 1 of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new subsection:

“1(h) (1) (a) Tax imposed. There is hereby imposed a tax of 7.65 percent on so much of the adjusted gross income for the taxable year of that exceeds--

(A) \$500,000, in the case of

(i) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013;

(ii) every surviving spouse (as defined in section 2(a)); and

(iii) every head of a household (as defined in section 2(b)), ;

(B) \$250,000, in the case of

(i) every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703); and

(ii) every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013;

(C) \$7,500, in the case of every estate and every trust taxable under this subsection.

(b) Credit for hospitalization tax paid. There shall be allowed as a credit against the tax imposed by this subsection so much of the amount of hospitalization tax paid by the individual with respect to his wages under subsection 3101(b) and to his self-employment income under subsection 1401(b) of this Title as exceeds the following amounts:

A) In the case of individuals described in subparagraph (1)(A) of this subsection, \$14,500; and

B) In the case of individuals described in subparagraph (1)(B) of this subsection, \$7,250.

### **Shared Economic Growth – Bill and Computations Summary**

The Shared Economic Growth bill allows a corporate dividends paid deduction, restricted to taxable income otherwise reported decreased by 2.85 times any credits claimed, so that the deduction may only reduce tax to zero. Excess reductions could be carried back 2 years and forward 20, so there would be incentive to pay out earnings with 2 years. Subsection 2(a) of the bill makes this change, with Subsections 2(b), (c) and (d) making certain conforming changes to the existing corporate dividends received deduction provisions.

In 2006 corporations paid tax of \$353 billion, so offsets of up to \$353 billion would be required for static revenue neutrality. The first and most natural offset is individual tax payable on the dividends paid. In order for the proposal to work, special rates for dividends and for capital gains on equity would need to be eliminated, so that these dividends would be taxed at full 2011 individual rates. Subsection 2(e) repeals these special rates. Per the Joint Committee on taxation 2006-10 tax expenditure report, this would have provided an offset of \$92.2 billion for 2006 without altering the various special capital gains exemption and rollover provisions. As a practical matter, this offset is only feasible in conjunction with the allowance of a dividends paid deduction, since such a deduction eliminates double taxation on the corporate side and thus eliminates any legitimate argument in favor of the capital gains rate benefits. As is noted below, the bill provides substantial excess offsets, so select non-equity capital gain rate benefits could be retained if desired.

Subsection 2(f) provides an offset mechanism that is only possible in conjunction with enactment of a dividends paid deduction. Because the deduction would effectively eliminate taxation of corporate income, including foreign income, it would no longer be necessary to allow a corporate credit for foreign taxes paid. A deduction could be permitted instead with the same bottom line effect. However, allowance of a deduction would impel corporations to pay out more dividends in order to eliminate the corporate level tax on the foreign income, which in turn increases the offset at the individual level. With this provision, the individual level offset from full 2011 rate taxation of the dividends needed to reduce corporate tax to zero would be some \$153.6 billion, after factoring out shareholders not subject to tax.

Section 3 provides another offset only feasible in conjunction with a dividends paid deduction. Foreign investors are effectively paying the 35% U.S. corporate level tax on their investment earnings. Congress would not have to let them have the benefit of the dividends paid deduction, since U.S. resident shareholders would have to pay full rate tax on such dividends. So, Section 3 imposes a 35% incremental withholding tax on dividends paid to foreign portfolio holders, exemption certain qualified foreign parent companies. This offset figure is somewhat inflated because I lack data to sort out the portion attributable to qualifying foreign parents corporations versus portfolio investors.

Section 4 provides the final offset, which the draft bill sets at a much higher level than necessary, since there is a certain attraction in subjecting individual income over \$500,000 a year to an AGI tax equivalent to the individual portion of the FICA taxes that ordinary wage earners pay. **The minimum level needed for this levy is some 2.65%.** At a 7.65% level, this levy would offset the revenue attributable to dividends paid to non-taxable retirement plans, so in effect this levy is requiring high income individuals to pay a supplemental tax similar to FICA taxes that supports non-social security private and state pension savings, thereby taking pressure off of the social security system. **Moreover, because these retirement savings will ultimately be paid out and taxed (at an average rate of some 17.66% after exclusions (as computed from the 2006 IRA/pension/annuity distribution income by AGI class), this would increase revenue by some 22.2 billion per year on a static basis as the pension income is paid out.** Use of a 7.65% rate **provides an excess offset of \$67.6 billion** that can be used to reduce the other offsets or to provide other compensating benefits or deficit reduction.

The static computations, based on 2006 IRS, JCT and Federal Reserve data, are reproduced in summary below and are available in full on request. I should note a computation relating to a variant from the static model. The static model ignores the fact that if corporations pay out a higher share of their earnings as dividends, capital gains taxes that would otherwise be payable under current law would be reduced, since a portion of capital gains tax collections pertain to gains flowing from the increment in share values attributable to retained earnings. The sensitivity computation below shows that at worst this effect would not be large enough to invalidate the model. The static model already conservatively accounts for taxes payable under current law on dividends that are normally distributed. The maximum effect of the above-described capital gains interaction is thus computable based upon the incremental taxable dividends as computed in the model. This results in the following computation.

Maximum reduction in capital gains tax due to elimination of capital

gains attributable to earnings that would otherwise be retained	
Incremental dividends subject to tax	\$454,991,419
Times 65% to account for earnings reduction from corp tax under current law	\$295,744,423
Times 20% maximum capital gains rate	\$59,148,885
This is less than the excess offset	

**This computes the necessary offsets, based on IRS 2006 SOI data and Federal Reserve ownership data**

Total corporate tax collected	\$353,083,862
Foreign tax credits used	\$78,183,457
Incremental tax if FTCs replaced by deductions	\$50,819,247
Adjusted corporate tax for computation	\$403,903,109
Grossed up by dividing by 35% to obtain value of dividends required to reduce corporate tax to zero	\$1,154,008,883
Qualifying taxable dividends reported by shareholders	\$137,195,800
Percentage of stock held by retirement funds	31.14%
Percentage of stock held by state & local gov't	0.52%
Percentage of stock held by foreigners	17.02%
Total dividends % not subject to income tax	48.68%
Implied non-taxable dividends paid	\$130,160,817
Incremental dividends to reduce corporate tax to zero	\$886,652,266
Incremental dividends subject to tax	\$454,991,419
Individual tax on those incremental dividends	156,287,339
Remaining offset needed	\$196,796,523
35% withholding on foreign shareholders	\$68,747,233
Remaining offset needed	\$128,049,290
Capital gains & dividends rate benefit	\$92,200,000
Remaining offset needed	\$35,849,290
2.65% AGI tax on income > \$500,000	\$35,849,290
Remaining offset needed	\$0

Note: At an AGI tax of 7.65% on income over \$500K, there would be an excess offset of \$67,550,274 allowing plenty of room to tweak the other offsets

**Based on 2006 IRA/pension/annuity distributions, the dividends going to pension funds will ultimately be taxed at a weighted average rate after exclusions of**

Producing tax of	17.66%
	\$63,474,391

**Of which the incremental amount produced by SEG would be**

**\$22,216,037**