

Testimony Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
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Introduction

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to testify today regarding the recently released Ways and Means Committee discussion draft on international tax reform (the “Discussion Draft”).

My name is David Noren, and I am a partner at McDermott Will & Emery LLP (“McDermott”), where I provide international tax advice to multinational companies across a range of different industries. I previously served as legislation counsel on the staff of the Joint Committee on Taxation (“JCT”), where I also handled international tax issues. The views I am expressing here today are my own and do not necessarily represent the views of McDermott or any of its clients.

General Observations on the Discussion Draft

I would like to start by commending the Committee leadership and staff for producing such a detailed and thoughtful proposal in a difficult and important area of the tax law. For several years now, various official reports and proposals have recommended the adoption of a territorial dividend exemption system,¹ but the debate could proceed only so far without detailed legislative language. The Discussion Draft provides this detailed language and thereby makes a major

¹ See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, at 186-97 (Jan. 27, 2005) (proposing a territorial system); President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, at 132-35 and 239-44 (Nov. 2005) (proposing a territorial system); U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, at 54-63 (discussing territorial alternatives in generally favorable terms); President’s Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, at 89-91 (Aug. 2010) (discussing a territorial system in generally favorable terms compared to other alternatives presented); National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, at 32-33 (Dec. 2010) (recommending the adoption of a territorial system); “Gang of Six” Senators, *A Bipartisan Plan to Reduce Our Nation’s Deficits*, at 4, available at 2011 TNT 139-28 (Jul. 2011) (recommending the adoption of a territorial system). While on the JCT staff, I worked on the JCT report cited above.

contribution to the territorial debate. While the language was only recently released, and thus is only beginning to be analyzed by the tax community (myself included), the language already has helped focus the community on some important territorial design issues that have previously received little attention in more general discussions of the territorial concept.

We will all be able to find aspects of the Discussion Draft that we would approach differently, and indeed the Discussion Draft itself does not purport to resolve conclusively every last issue that it raises, but as we set about the work of trying to improve on the Discussion Draft, we should do it with considerable appreciation for the Members and staff who took the important step of putting this proposal together and opening it up for comments so early in the tax reform process.

I recently published an article in which I considered several of the key technical issues raised by adopting a territorial tax system.² In my article I emphasize that the word “territorial” can be used to describe quite different approaches to taxing U.S.-based multinationals, and that the devil will be in the technical details of how a territorial system is implemented.

The one essential feature of a territorial dividend exemption system is that dividends from foreign subsidiaries are substantially exempt from U.S. Federal income taxation. This dividend exemption removes certain distortions of corporate financing and cash management decisions that arise under the current system of repatriation-based taxation of foreign earnings (a phenomenon sometimes referred to as the “lock-out effect”). This is a problem well worth solving, and the territorial path is one that has been taken by most of our major trade and investment partners.

Beyond removing these distortions of the current system, the net effect of adopting a territorial system will depend critically on the resolution of key design issues raised by exempting foreign subsidiary dividends. These issues include how to treat domestic expenses that might be viewed as allocable and apportionable to exempt foreign income, whether to provide full dividend exemption or instead exemption with a “haircut,” the nature and extent of the continued role of the foreign tax credit, the scope of the “subpart F” controlled foreign corporation (“CFC”) regime, and the mechanism for transitioning from the current system to the new system, to name just a few. Depending on how issues like these are resolved, a territorial system could increase, decrease, or have a roughly neutral effect on the overall U.S. tax burden on U.S.-based multinationals.

The Discussion Draft seeks to implement a territorial system on a revenue-neutral basis, having first assumed that the top corporate income tax rate will be reduced to 25 percent as part of the broader tax reform process. In pursuit of this goal, the Discussion Draft includes several provisions designed to protect the U.S. fisc. My testimony today focuses on one set of these provisions, specifically the Discussion Draft’s three alternative subpart F proposals addressing

² David G. Noren, “Designing a Territorial Tax System for the United States,” 40 Tax Mgmt. Int’l J. (BNA) 643 (Nov. 11, 2011). The Discussion Draft was released after the article had gone to press, but prior to the article’s publication date.

concerns about the potential erosion of the U.S. tax base through the shifting of income to low-tax jurisdictions.

The Discussion Draft’s “Base Erosion” Provisions

Does the adoption of a territorial system require the introduction of further subpart F or transfer pricing restrictions?

A threshold question is whether adopting a territorial system would place significant additional pressure on the transfer pricing and subpart F rules, thus requiring either or both sets of rules to be made more restrictive. Some would argue that, by converting present law’s deferral into permanent exemption or near-exemption, incentives for income shifting may increase significantly, and thus territoriality should not be pursued without the introduction of new measures to tighten the transfer pricing and/or the subpart F rules, which together serve to limit income shifting.

My view, as discussed in the aforementioned article, is that adopting a territorial tax system is unlikely to place significant additional pressure on the transfer pricing and subpart F regimes. Taxpayers already have strong incentives under the deferral system and applicable financial accounting principles to take the most advantageous transfer pricing and subpart F positions that they can support at an appropriate level of confidence, and the transfer pricing and subpart F rules, for all of their flaws, do impose real limits on income shifting. Converting indefinite deferral into 95-percent exemption should not dramatically alter the transfer pricing practices of most large multinationals. Some multinational companies may face strong domestic liquidity constraints and lack foreign growth opportunities, in which case the elimination of the high-rate repatriation tax might represent a more meaningful change in income-shifting incentives, but these situations should be relatively uncommon.

For these reasons, I think that questions relating to the proper scope of the transfer pricing and subpart F rules are largely independent of whether a deferral or a dividend exemption approach is pursued, and that the adoption of territoriality in and of itself does not create any new imperative to tighten these rules.

The Discussion Draft’s proposed reduction of the top corporate income tax rate to 25 percent actually may have more bearing on the proper approach to transfer pricing and subpart F issues than does dividend exemption itself. Specifically, a case could be made for taking a more restrictive approach to transfer pricing and subpart F issues as the corporate rate is reduced to a level more in line with the rates applicable in other OECD countries, although the strength of such a case would of course depend on the nature and scope of the restrictions in question. In the absence of a major rate reduction, making the transfer pricing or subpart F rules more restrictive could produce effective tax rates for U.S.-based multinationals that would be excessively high by international standards.

If further subpart F restrictions are in order, what exactly is the targeted behavior?

The Discussion Draft’s three alternative subpart F proposals targeting U.S. base erosion reflect three quite different ways of further limiting the ability of taxpayers to shift income to low-tax

jurisdictions, and ultimately three different theories of what behavior is thought to be objectionable.

Is it the earning of profits from intangible property (“IP”) by a CFC? If so, does it matter whether the IP was developed entirely within the United States, entirely outside the United States, or partly within and partly outside the United States? Are low foreign effective tax rates a concern in and of themselves, or only when paired with other factors, such as IP return or a lack of certain kinds of business activities in the relevant jurisdictions? To what extent does it matter whether a CFC is earning income from servicing its home-country market, foreign markets in general, or the U.S. market? How are concerns about potential income shifting to be balanced against other economic policy concerns, such as U.S. employment and innovation leadership? Each of the three alternative proposals provides different answers to these questions.

Option A (“excess returns” proposal)

Option A, which is substantially similar to the Obama administration’s “excess returns” proposal, reflects a concern about U.S.-developed IP being transferred to a CFC. Under Option A, if a U.S. person transfers IP to a related CFC, then the CFC’s “excess” income from transactions benefiting from the transferred IP and subject to a “low” foreign effective tax rate would be subpart F income. “Excess” income is generally defined as any amount of gross income above 150 percent of directly allocable and apportionable costs (not including interest or taxes). A foreign effective tax rate of 10 percent or less is “low,” with sliding-scale application of the rule for effective tax rates between 10 percent and 15 percent. A relevant IP “transfer” may have occurred at any time, even prior to the provision’s effective date, and may have occurred by way of cost-sharing or co-development arrangements typically not thought to entail a transfer of IP. A narrow home-country exception is provided for income earned by a CFC from sales into its own home-country market or the performance of services there.

Although the proposal speaks in terms of IP being transferred from the United States, the proposal as currently drafted could taint an entire income flow that is attributable in large part to foreign-developed IP, based on the presence of relatively minor U.S. IP relating to the relevant product or service. In other words, the proposal does not narrowly address U.S.-developed IP, but rather creates a “cliff effect” based on the presence of any relevant U.S.-developed IP at all.³

Whether or not this cliff effect is addressed, the most fundamental concern about the excess returns proposal is that it might encourage the migration of R&D activity from the United States. If all IP relating to a product is developed abroad, then the proposal does not apply to the income generated by the product. If new restrictions on income shifting are thought to be necessary, it may make sense to develop an approach that is more neutral with respect to the locations where R&D work is performed. The United States does not have a monopoly on talent, and we should keep this fact in mind as we contemplate tax policies that would impose new burdens on the performance of economically critical activities here.

³ The proposal is not technically geared to where IP is developed, but rather to whether it is transferred by a related U.S. person. In referring to the location of IP development, I have in mind the practical effects of the proposal, as opposed to the mechanism by which those effects are produced.

Another concern about the proposal relates to the scope of the costs included in the base that is marked up under the 150-percent rule in determining excess income. It appears that a CFC's costs of goods sold ("COGS") might *not* be marked up under this rule, whereas other costs would. This would result in harsher treatment of a higher-COGS CFC relative to a lower-COGS CFC, even if both CFCs earn the same net income from products involving U.S.-developed IP, because less of the former CFC's total costs would be uplifted for purposes of determining any excess income. This seems like an arbitrary result.

Similarly, the treatment of royalties paid by a CFC for purposes of the excess income determination needs further clarification. Royalties may be an element of COGS in many situations and thus may be affected by the uncertainty surrounding the COGS issue. The proposal does specify that R&D costs are marked up under the 150-percent rule, which would seem to embrace situations in which a CFC bears R&D costs in a cost-sharing, co-development, or R&D services arrangement, but in many cases it will not be clear that royalties paid by a CFC for the use of IP in producing a product or performing a service will count as R&D costs for this purpose. If a CFC pays a royalty for the use of IP relating to the product or service that the CFC sells, it would seem appropriate to include these royalties as relevant costs in determining the extent of any excess return.

In sum, Option A could be improved in important respects by addressing various technical points, but it seems unavoidable that this option entails significant tension between the goal of restricting income shifting on the one hand and pursuing other economic policy goals involving the preservation and creation of U.S. R&D jobs and U.S. leadership in innovation on the other hand. The proposal may deserve further consideration if further restrictions on income shifting are thought to be necessary, but there are clearly some major issues to be surmounted.

Option B ("low tax" proposal)

Option B provides that a CFC's gross income that is subject to a foreign effective tax rate of 10 percent or less is subpart F income, subject to a narrow home-country exception. The home-country exception applies only if: (1) the income arises from the conduct of a trade or business in the CFC's country of organization; (2) the CFC maintains an office or fixed place of business in such country; and (3) the income is derived in connection with property sold for use in such country or services provided with respect to persons or property located in such country. Due to the last condition of this three-part conjunctive test, unless a CFC is essentially selling into its own home-country market, an effective tax rate of 10 percent or less will lead to the treatment of the CFC's income as subpart F income, regardless of the other facts and circumstances surrounding the CFC's earning of the income. The effective tax rate analysis is to be done on a country-by-country basis for each country in which the CFC has a trade or business, although the mechanics of how this separate-country analysis should apply are not specified in great detail. Option B does not rely on any attribution of income flows to any particular kind of IP (or to IP at all).

Option B might be improved by providing a somewhat broader home-country exception that would accommodate structures with some significant substance in the country of organization, even if the CFC is selling into other markets. For example, the rules could require that the CFC's employees make something akin to a "substantial contribution" to the relevant revenue-

generating activities.⁴ Because Option B applies to a broader category of taxpayers and activities than do the foreign base company sales income rules to which the existing substantial contribution test relates, the substantial contribution concept would need to be expanded somewhat to serve this purpose (i.e., it would need to embrace activities beyond those relating closely to a manufacturing supply chain, such as marketing, sales, and general managerial activities, as well as activities relating to services businesses).⁵ A balance would need to be struck between providing sufficiently robust requirements to prevent the avoidance of the low-tax rule through the use of entities with minimal functionality (e.g., the performance of purely clerical or ministerial functions), while not requiring so much foreign activity as to encourage substantial migration of key functions from the United States to foreign locations. As noted previously, the goal of preventing income shifting is often in some tension with other economic policy goals, so caution is warranted.

Potential points of technical clarification under Option B might include clarifying that income inclusions are pro-rated in situations in which a CFC has both “good” and “bad” streams of income and clarifying the operation of the country-by-country determinations in situations involving CFC trades or businesses in multiple countries.

Option C (“carrot and stick” IP taxation proposal)

Option C provides that all CFC income attributable to IP related to property or services sold or provided by the CFC is subpart F income, but a U.S. shareholder is entitled to deduct 40 percent of income attributable to IP relating to property sold into foreign markets or services provided with respect to persons or property outside the United States (whether such income takes the form of a subpart F inclusion or a direct receipt, such as a royalty). Thus, IP-related income is tentatively taxed on a current basis at the new generally applicable top corporate rate of 25 percent, and then the portion of such income relating to serving foreign markets, as opposed to U.S. markets, is 40-percent deductible, leading to a current-basis U.S. effective tax rate of 15 percent [$.6 * .25$] on the latter portion of the income (leaving aside the additional 1.25 percent tax to come at the time of distribution of subpart F earnings, due to the Discussion Draft’s elimination of the “previously taxed earnings” rules).

The general subpart F high-tax exception would apply to this new category of subpart F income, using 13.5 percent [$.9 * .6 * .25$] as the relevant threshold, although this threshold presumably was not intended to apply for purposes of all “foreign base company intangible income,” but rather to just that portion of such income constituting “foreign intangible income” from serving foreign markets.

IP is broadly defined for these purposes. Unlike the excess returns proposal, this proposal seeks to limit its application to the income actually attributable to IP, but the proposal does not specify how this attribution is to be done.

⁴ See Treas. Reg. sec. 1.954-3(a)(4)(iv) (establishing a “substantial contribution” category of manufacturing for purposes of the manufacturing exception under the subpart F foreign base company sales income rules).

⁵ A similar exception could also be added to Option A.

Option C is a very inventive proposal that essentially boils down to current-basis taxation of IP profits, with a preferential rate being applied for IP profits relating to serving foreign markets, and a normal rate being applied for IP profits relating to serving the U.S. market (sometimes pejoratively referred to as “round-tripping” transactions). The preferential rate represents a variation on “IP box” approaches implemented or considered by other countries and could serve to mitigate certain additional tax burdens that the adoption of a territorial system might otherwise impose on companies that earn a large portion of their IP return in the form of currently taxable income of a U.S. company, like royalties (due to the loss of the foreign tax credit averaging that reduces the U.S. tax burden on these royalties under the current deferral system). At the same time, the imposition of current-basis taxation seeks to further restrict income shifting.

Option C is complex, and perhaps more than any other aspect of the Discussion Draft will require further study on the part of the tax community before a fully informed judgment can be made. A key issue will be how to attribute income to IP, which could create a need for valuation and transfer-pricing-type analyses of a kind not required under present law.

A broader concern for taxpayers might be that Option C to some extent resembles a repeal of deferral, with some of the income being subject to lower rates. Although such an approach could in concept be attractive to taxpayers if a sufficiently low rate could be implemented and then maintained, historically there has been concern that rates might be too easily amended under such a system, making it difficult for taxpayers to be assured of a reasonably stable effective tax rate over time.

A potential variation on this concept might be simply to administer the Discussion Draft’s dividend “haircut” on a current basis, rather than allowing it to be deferred. This would ensure current-basis taxation of all of a CFC’s income at a low rate (1.25 percent, assuming a 5-percent haircut and a 25-percent general rate), with no offset by foreign tax credits under the Discussion Draft’s approach to the foreign tax credit rules, and with present-law subpart F and transfer pricing rules continuing to apply. This variation would serve to reduce income-shifting incentives to some extent, without getting into the definitional and other complexities raised by creating entirely new categories of subpart F income. This variation also might be seen as a slippery step toward more general and higher-rate current-basis taxation of CFC income, but it would be considerably more limited and potentially less complex than some of the more ambitious alternatives.

The Discussion Draft’s base erosion alternatives in the broader subpart F context

Another set of issues relating to the Discussion Draft’s base erosion alternatives involves how these proposals fit into the existing subpart F framework. The Discussion Draft does not eliminate any of the existing categories of subpart F income, but rather would apply the new restrictions concurrently with the existing ones.⁶ If the existing subpart F rules are indeed thought to be inadequate in controlling income shifting, and a new approach can be found that

⁶ The Discussion Draft would repeal the deemed-repatriation rules of section 956, but this is essentially a conforming change in adopting a territorial system.

more appropriately balances the various competing policy considerations, then perhaps that new approach should replace the existing subpart F categories rather than sitting alongside them. The adoption of a territorial system thus could serve as an opportunity for a broader reform and simplification of the subpart F rules, instead of just making subpart F more restrictive and complex.

The Discussion Draft is also silent on the subject of the CFC look-through rule of Code section 954(c)(6) and the subpart F active financing and insurance exceptions. These provisions or something like them would remain important under a territorial system. It presumably should not be inferred from the Discussion Draft's silence regarding these temporary (and soon-to-expire) provisions that the provisions are on the chopping block in connection with an international tax reform effort.

A final subpart F issue that deserves notice is the Discussion Draft's elimination of the rules providing for the tax-free distribution of previously taxed earnings under Code section 959 and the related basis adjustment rules of Code section 961. While this repeal may accomplish a simplification of the law and raise some revenue, some will question the basis for taxing subpart F income more heavily than purely domestic income. In addition, if this approach is pursued, there will be a particular need to coordinate this approach with efforts on the individual and general business taxation fronts to ensure that U.S. shareholders who are not entitled to territorial dividend exemption do not suffer a second application of full-rate U.S. tax on their subpart F income when earnings are distributed.

Conclusion

I thank you again for the opportunity to present my views on this important subject, and I again commend Committee leadership and staff for advancing the debate in this area. While I have offered much constructive criticism in this testimony, my predominant reaction is one of appreciation and respect for the impressive work that the Discussion Draft represents. I would be pleased to answer any questions you may have at this time or in the future.