TESTIMONY OF ROBERT STRICOF
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ON
TAX REFORM AND FOREIGN INVESTMENT IN THE UNITED STATES
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE
HOUSE COMMITTEE ON WAYS & MEANS

JUNE 23, 2011

Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss my views on international tax reform as it relates to the U.S. operations of foreign multinationals. I am a Tax Partner with Deloitte Tax LLP with over thirty years of experience as a tax accountant. I am the head of Deloitte's Global U.S. Investment Services group, which serves large foreign multinationals making investments into the United States. My practice has largely focused on serving industrial companies and service businesses.

I am honored to have been invited to participate in this hearing. My remarks will focus on certain impediments posed by the U.S. income tax rules on foreign direct investment in the United States and technical comments regarding certain legislative proposals that affect multinationals investing in the United States.

Earnings Stripping

For many years there has been significant debate surrounding whether evidence exists of foreign multinationals systematically eroding the U.S. tax base through claiming deductions for inappropriate levels of interest expense to foreign related parties (so-called "earnings stripping"). In the American Jobs Creation Act of 2004 (P.L. 108-357), Congress directed the Department of the Treasury to conduct a study of the issue. In November of 2007, the Department of the Treasury issued its report to Congress

on *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*.[1] With respect to historically foreign based companies making direct investments in the United States, the Treasury Department reported it did not find conclusive evidence of earnings stripping.[2] In order to further its study of earnings stripping and assure that it had the data needed to determine whether earnings stripping is in fact a systematic problem, the Treasury Department issued Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information (the "Form").

From my vantage point as a tax accountant, I have little to add to the economic debate as to whether there is evidence of wide spread earnings stripping or not. However, I am concerned regarding the use of the Form as a means by which to try and advance the discourse in this area. The Form has numerous errors and areas where clarification is needed. Notwithstanding taxpayer comments on the Form,[3] these issues have not been resolved in the four years since the Form's issuance. Thus, I am concerned the Form will not advance the study of the area and it may lead to false conclusions.

One of the fundamental problems with the Form is rooted in the lack of guidance regarding how to apply the earnings stripping rules of section 163(j). Proposed section 163(j) regulations were issued in 1991 and many interpretive questions regarding the application of section 163(j) remain unresolved. However, the form is unclear whether a taxpayer is to rely on the proposed regulations or not in filling out the Form. As a result, similarly situated taxpayers may be filling out the form differently. Thus, the quality of the data retrieved from the Form is unlikely to lead to reliable conclusions.

Although the Form may be unable to serve its intended purpose, it remains a compliance burden for taxpayers. In addition, instead of easing the administration of section 163(j), my experience has been

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[1] Hereinafter referred to as the "Treasury Report."
[2] Treasury Report, pg 4. For other discussions regarding the evidence of earning stripping, *see OFII White Paper on Related Party Interest Expense*, 2003 TNT 154-53 (April 7, 2003).
[3] *See, e.g.,* Parillo, Kristen, *International Business Association Seeks Revisions to Proposed IRS FORM 8926*, 2008 TNT 44-4 (March 5, 2008).

that the Form has lead to confusion amongst IRS examiners regarding the application of the rules. For example, the Form requires taxpayers to provide information regarding the so-called "debt-to-equity safe harbor" of section 163(j)[4] even if a taxpayer is not relying on the safe harbor. This has lead some IRS examiners to believe a taxpayer that fails to satisfy the safe harbor should be subject to a disallowance with respect to deductions for its interest expense, even if the taxpayer does not run afoul of the general rules of section 163(j) and thus, no interest expense should be disallowed. Consequently, I would ask that the Subcommittee urge the IRS to correct and clarify the Form.

Determination of Corporation Residency Based on Management & Control

In the last several Congresses, proposals were introduced to treat companies that are organized or incorporated in foreign countries as U.S. corporations if the management and control of the corporations occurs (directly or indirectly) primarily within the United States.[5] The proposals would treat the management and control of a corporation as occurring primarily within the United States if "substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States."

The proposal has a variety of shortcomings relative to the current law that determine whether a company is treated as domestic or foreign based on its place of organization or incorporation. I urge the Subcommittee to retain the current rules for determining corporate residence.

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[4] A payor of interest is not subject to a disallowance for interest deductions with respect to interest paid or accrued by a corporation in a taxable year if the payor's debt-to-equity ratio does not exceed 1.5 to 1 (the so-called "safe harbor" ratio).

[5] International Tax Competitiveness Act of 2011, H.R. 62, 112th Cong., 1st Sess. (January 5, 2011); International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong., 2nd Sess. (May 18, 2010); Stop Haven Abuse Act, S. 506, 111th Cong., 1st Sess. (March 2, 2009), H.R. 1265, 111th Cong., 1st Sess. (March 3, 2009); *See also*, Joint Committee on Taxation, Options To Improve Tax Compliance And Reform Tax Expenditures (JCS-2-05) (January 29, 2005).

1. Loss of High Paying Jobs in the United States

First, the management and control proposal is at odds with the realities of global markets and could create inappropriate tax pressures on the location of talent. Increasingly, multinationals are filling their executive ranks based on where the top talent is without regard to nationality. Thus, many multinationals (foreign and U.S.) have all or part of their management located outside the country of organization of their parent company. In addition, because many foreign multinationals with significant operations outside the United States also have substantial operations in the United States, it is not uncommon for one or more officers of a U.S. subsidiary to sit also on the global management committee of the foreign parent. The management and control proposal would likely cause foreign multinationals to limit the participation of U.S. executives in policy decisions. Moreover, the proposal could cause foreign multinationals to choose to locate top management outside the United States. All of these possible outcomes would result in the loss of high paying jobs in the United States.

2. Anti-Competitive

Second, the substance of the proposal is out of step with the approach taken by other countries that have adopted a management test to determine corporate residence. Some commentators have argued this proposal is similar to the manner in which many of our major trading partners determine corporate residence. While it is true that many countries look to the place of a corporation's management to determine its tax residence, these countries often focus on the place where the board of directors' meetings occur and do not require such a detailed factual determination based on the location of the day-to-day management of certain decision makers in the company's "chain of ownership."[6] I am unaware of any country that determines corporate residence under a management and control test such as the current proposal.

[6] *See generally*, NYSBA Tax Section Report (No. 1232) to Congress, IRS, Treasury on The Management and Control Provision of The International Tax Competitiveness Act of 2011 (January 31, 2011).

3. Application Should be Limited to Treaty Qualification

Advocates for the management and control proposal point to its use in recent U.S. income tax treaties as an indication that the test should also be used to determine corporate residence. However, the management and control test is infrequently relied upon in U.S. income tax treaties precisely because of the numerous questions regarding how it is to be applied. Alternative tests are provided in U.S. income tax treaties to establish one's eligibility for treaty benefits. In addition, the treaty management and control test applies only to a single company, the public company at the top of a multinational's structure, not to each and every subsidiary as required under the proposal. Moreover, the complexity and administrative issues inherent in applying the management and control test are more palatable in the treaty context, where there is one of several alternative tests available to obtain benefits. It is far different when such a test is the only applicable test for determining corporate residence and when very significant tax consequences result from this determination, such as the application of the U.S. worldwide system of taxation.

In addition, there are numerous interpretative questions regarding the manner in which the proposal would be applied. For example, it is unclear who within management of a given company might fall within the ranks of the "executive officers and senior management" given the different organizational and management structure within any given company. It is also unclear what it means to "exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation." For example, how should the test be applied in the context of a company with a decentralized management model? The interpretation of the level of managerial functions conducted in the United States is not an issue that is likely to be determined in a consistent manner during the IRS audit process.

4. Increased Administrative and Compliance Burden

Finally, the proposal would replace an objective, easily administered and easily complied with standard with a subjective and highly factual standard. Given the significant tax consequences that flow from the determination of corporate residence, the proposal would lead to significant administrative issues for the IRS and taxpayers trying to comply with the law.

Just one narrow example of these administrative issues relates to the application of our U.S. income tax treaties. Many of our current tax treaties have tiebreaker rules for dual resident corporations that would require the competent authority to resolve the tie in an instance where a corporation is treated as a resident in such a treaty country because of its place of organization and is also treated as a U.S. resident because of its place of management and control.[7] The U.S. competent authority would likely have numerous requests for such determinations.

Given the administrative, technical and policy concerns surrounding the management and control proposal, I would urge the Subcommittee to retain the current law rules for determining corporate residence.

Denial of Treaty Benefits if Parent Corporation not in Treaty Country

The Ways and Means Committee has also considered a legislative proposal that would override all of our tax treaties. The proposal has been included in numerous bills since 2007.[8] Although it has never been enacted, I want to raise several concerns about the proposal in the context of this Subcommittee's consideration of tax reform.

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[7] 2006 U.S. Model Income Tax Convention, arts. 4(1) and 4(4) (November 15, 2006).

[8] *See, e.g.,* Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849, 111th Cong., 2nd Sess. (March 16, 2010); James Zadroga 9/11 Health and Compensation Act of 2010, H.R. 847, 111th Cong., 1st Sess. (February 4, 2009).

The proposal would deny the availability of reduced withholding taxes for tax deductible payments (i.e. interest and royalty payments) between two members of the same foreign controlled group of entities (generally "a more than 50%" threshold) if the common foreign parent would not be eligible for a reduced withholding tax rate if it received the payment directly.

1. Proposal No Longer Needs to Address Treaties without Limitation on Benefits Articles

The precise target of the proposal is unclear. One interpretation is that the proposal was originally geared toward addressing U.S. income tax treaties that did not have anti-treaty shopping provisions (i.e., limitation on benefits provisions) such as the U.S. treaties with Hungary, Poland and Iceland. Since the proposal's initial introduction in 2007, the United States has concluded new treaties with Iceland, which is currently in effect, and Hungary, which is awaiting Senate action. In addition, earlier this month, the Treasury Department indicated that it had concluded the negotiation of a new income tax treaty with Poland, which it hopes to sign and transmit to the Senate for its advice and consent soon.[9]

2. The Active Trade or Business Test in Treaties Should not be Overridden by Statute

Given the proposal's breadth, another interpretation of the proposal's intended target is a particular manner in which treaty benefits can be obtained in those treaties that do have anti-treaty shopping provisions, namely the so-called "active trade or business test." The proposal as currently written would generally override our U.S. tax treaties in the case of a foreign corporation resident in a treaty country qualifying for treaty benefits with respect to U.S. interest and royalty payments if such foreign corporation was owned by a corporation in a non-treaty country. The active trade or business test in our income tax treaties is the most common manner such a company would qualify for U.S. treaty benefits.

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[9] *Opening Statement of Manal Corwin Treasury Deputy Assistant Secretary (International Tax Affairs) Senate Committee on Foreign Relations*, 2011 TNT 110-40 (June 7, 2011).

The active trade or business test is the most fact intensive of the tests under which one could qualify for U.S. treaty benefits and the only test that requires a showing of a nexus between the U.S. income for which benefits are being claimed and an active business in the other state. The active trade or business test determines the qualification for treaty benefits based on a foreign tax resident deriving the U.S. income in an active trade or business in a treaty country and that the size of that active business is substantial in relation to the business in the United States. Given this, it is arguably the most rigorous of the tests available to determine treaty qualification. The active trade or business test should not be subject to a treaty override.

3. Treaty Overrides Undermine the U.S. Treaty Network and U.S. Multinationals Seeking Treaty Benefits

The proposal as currently written would generally override every treaty in the U.S. tax treaty network -- even those with our largest trading partners -- under the facts that I have described. Treaty overrides, such as the proposal, undermine the U.S. treaty network and suggest to other countries that not abiding by the terms of our tax treaties is acceptable practice when U.S. resident companies seek to obtain treaty benefits from our treaty partners. The active trade or business test has become part of the U.S. standard on what is acceptable treaty practice and is in the U.S. model income tax treaty. The maintenance of these standards and our U.S. income tax treaty network is essential to facilitate the cross border movement of capital with respect to the conduct of active business operations.

I would urge the Subcommittee to consider retaining the current law rules regarding obtaining treaty benefits.

FIRPTA

I would also like to offer a comment with respect to our FIRPTA rules[10] and the administrative burden they pose on corporate transactions in instances where the policy concerns underlying the enactment of these rules are not at issue.

The FIRPTA rules provide that gain or loss of a nonresident individual or foreign corporation from the disposition of a U.S. real property interest is taken into account as if the foreign person were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected to that trade or business. The definition of a U.S real property interest generally includes an equity interest in a domestic corporation, unless the foreign person establishes that at all times during the five year period ending on the date of disposition less than 50 percent of the fair market value of the domestic corporation's assets is from U.S. real property interests.

In the case of transactions, including otherwise tax-free reorganizations, involving foreign owners of U.S. corporations, a filing declaring that a U.S. corporation does not meet this 50 percent threshold is required, generally, prior to the execution of the transaction, to avoid penalties and interest. If the filing requirement is not satisfied, an administrative procedure may be available to obtain relief. In the context of intercompany transactions, where it is widely known that a U.S. corporation that is a party to a transaction does not run afoul of the 50 percent threshold, the presumption in the FIRPTA rules creates an unnecessarily onerous burden on both taxpayers and the IRS. I would urge the Subcommittee to consider removing the presumption in the case of intercompany transactions.

[10] The Internal Revenue Code contains a series of provisions collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") in sections 897, 1445, 6039C and 6652(f).

FBAR

Finally, I would like to offer a comment with respect to the foreign account reporting rules for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, (so-called "FBAR reporting") and their affect on inbound companies. Any United States person who has a financial interest in or signature authority over any financial account(s) located outside of the United States is required to comply with FBAR reporting if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year. FBAR reporting is required of individuals who have signature authority over a foreign employer's foreign accounts, e.g., in order to disperse payroll or pay vendors, unless the foreign employer meets an exception for companies that are publicly traded on a U.S. exchange. U.S. employees of foreign multinationals with direct investments in the United States, for example, through a branch operation in the United States may come within the scope of such reporting without any apparent purpose. These U.S. employees do not have a personal financial interest in these foreign accounts and their foreign employers are not subject to U.S. reporting obligations.

I would urge the Subcommittee to consider the scope of these rules to assure that they do not extend beyond their intended purpose in the inbound context.

Conclusion

Thank you for the opportunity to share with you my views on tax reform in the context of foreign direct investment. I would be happy to answer any questions.