STATEMENT OF DIRK SURINGA
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS & MEANS
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE SUBJECT OF
THE REPATRIATION OF FOREIGN EARNINGS AS A SOURCE OF FUNDING FOR THE HIGHWAY TRUST FUND

JUNE 24, 2015

Chairman Reichert, Ranking Member Neal, and Members of the Committee:

My name is Dirk Suringa. I am a partner in the law firm of Covington and Burling LLP. From 2000 to 2003, I served as an Attorney-Advisor in the Office of International Tax Counsel in the Department of the Treasury. I appreciate very much the opportunity to testify today before the Committee. I appear before you today on my own behalf and not on behalf of my firm or any firm client.[1]

I am testifying as a practitioner who works with the existing rules for the taxation of U.S. companies operating abroad. I would like to focus my testimony on two recent developments, which may be important to the Committee as it addresses the topic of the repatriation of foreign earnings. These two developments are, first, the OECD's Base Erosion and Profits Shifting ("BEPS") Project, which has led to increased double taxation of U.S. companies operating abroad; and, second, the recent proliferation of foreign research tax incentives called "patent boxes," a phenomenon which is expected to accelerate in the coming years. These and other related developments have increased the urgency for reform of the U.S. rules for taxing the foreign operations of U.S. companies.

Started at the behest of the G-20 in 2013, the OECD's BEPS Project has developed 15 Action Items, addressing technical tax topics ranging from transfer pricing of intangibles to the taxation of digital goods and services to the threshold for source-country taxation under the "permanent establishment" standard.[2] From its inception, the OECD's primary purpose in this Project has been to propose measures that governments can adopt to tax so-called "stateless income," defined as income not subject to current taxation by any country.[3]

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[1] Covington represents clients in the technology and pharmaceutical industries, among others, which have an interest in the matters discussed before the Committee today. We are not currently registered to lobby on behalf of these clients for such matters, but it is our expectation that we will register for one or more such clients in the near future.

[2] *See* Organisation for Economic Co-operation and Development [OECD], *Action Plan on Base Erosion and Profit Shifting*, at 13–27 (July 2013).

[3] *See id.* at 10 ("BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation.").

The BEPS Project assumes stateless income to be a pervasive problem and one that must be addressed by expanding the taxation of cross-border income. However, the BEPS Project does not clearly distinguish between stateless income from income earned in a country that decides for its own policy reasons not to tax it, or income that is subject to deferred taxation in the taxpayer's country of residence, such as the U.S. system of taxing certain foreign business income on a deferred basis.[4] Instead, the BEPS Project starts from the premise that multinationals—and in particular U.S. multinationals—are using "base erosion and profits shifting" techniques to avoid foreign income taxation, and it proceeds immediately to the conclusion that new and largely untested methods of taxation, or of allocating income to a country, must be devised to capture that tax revenue.[5]

So far, 7 of the 15 planned BEPS "deliverables" have been issued, and the remainder are expected this Fall.[6] However, the main practical effect of the BEPS Project already is being felt by U.S. companies operating abroad. The effect so far has been to undermine whatever consensus may have existed on several longstanding tenets of international taxation, such as the threshold level of activity required for a source country to tax a nonresident enterprise and the arm's length standard for transfer pricing—without replacing them with any new consensus. Countries thus have responded to the BEPS Project through a series of unilateral tax measures, such as the "Diverted Profits Tax," a tax regime adopted by the United Kingdom in April 2015 primarily to tax U.S. technology companies that were not subject to tax under the permanent establishment definition that existed before BEPS.[7] The U.K. is not alone in adopting or considering such measures.[8]

BEPS also has become a common pretext for aggressive foreign tax audits of U.S. companies. It has become a running joke among international tax practitioners that BEPS stands for "Basically Everything is a Profit Split," since many countries appear to be abandoning the arm's length standard in favor of taxing whatever they perceive to be their "fair share" of tax revenue from international trade.[9] Under one BEPS action item, "country-by-country reporting," the IRS plans to collect data from U.S. companies, including how much revenue and profit they earn in each country around the world, and the IRS would then share this information with

[4] *Cf. id.* at 9–11.

[5] *See, e.g., id.* at 8.

[6] *See id.* at 29–40 (laying out the BEPS deliverables timeline).

[7] *See* Kevin A. Bell, *U.S., U.K., OECD Delegates Differ On Evaluation of BEPS Project*, 34 T.M.W.R. 749 (June 15, 2015) (reporting on the "disappointment" of the U.S. Deputy Assistant Treasury Secretary for International Tax Affairs with the current status of the BEPS Project and recent unilateral action by the U.K. and Australia).

[8] *See id.*

[9] *See, e.g.*, David D. Stewart and Stephanie Soong Johnston, *Australian Tax Chief Challenges Multinationals' Claims*, 78 Tax Notes Int'l 327 (Apr. 27, 2015) (reporting on the hearings before the Australian Senate).

foreign governments.[10] Although this information is not intended to be used by foreign governments to lay claim to a share of the tax revenue allocated to other countries, it is difficult to imagine that it will not be used for that very purpose. As a result of these and other BEPS deliverables, U.S. companies operating abroad are becoming subject to double taxation of their income in an increasing number of cases. The new aggressiveness of foreign tax audits already is being reflected in the number of requests for treaty relief from foreign-initiated audit adjustments.[11]

A second development, related in part to BEPS, is the proliferation of foreign "patent box" regimes, which are foreign tax incentives designed to encourage companies to relocate research and development activities into the country offering the incentive. Although such regimes come in many varieties, in general terms, they are designed to grant a concessionary tax rate for income from the development and exploitation of intangible property, particularly patents, within a jurisdiction.[12] The OECD recently identified 15 separate preferential intangible regimes within OECD member states and associate countries: Belgium, Colombia, France, Hungary, Israel, Luxembourg, Portugal, the Netherlands, Spain (3 separate regimes), Switzerland (2 separate regimes), Turkey, and the United Kingdom.[13]

These incentive regimes are expected to spread further to other countries and, going forward, to concentrate more specifically on the relocation of skilled professionals.[14] In 2010, the existing preferential intangible regimes were subjected to scrutiny by the OECD and

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[10] *See* OECD, *Guidance on Transfer Pircing Documentation and Country-by-Country Reporting—Action 13: 2014 Deliverable* (Sept. 2014).

[11] *See* Dolores Gregory, *IRS Releases MAP Statistics for 2014 Showing Jump in Filings and Inventory*, 23 T.M.T.R. 1606 (Apr. 30, 2015) ("Requests for double tax relief jumped significantly in 2014, adding to a growing inventory of mutual agreement procedure (MAP) cases before the Internal Revenue Service, an agency official said, citing a report released April 16.").

[12] Joint Comm. on Tax'n, *Present Law And Selected Policy Issues In The U.S. Taxation Of Cross-Border Income*, JCX-51-15, at 41–47 (2015) [hereinafter *JCX-51-15*] (describing the general idea motivating the patent box along with differences between various patent box regimes).

[13] *See* OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance—Action 5: 2014 Deliverable*, at 59 (Sept. 2014) [hereinafter *Action 5 Deliverable*]. *See also* European Commission [EC], *A Study on R&D Tax Incentives: Final Report*, Working Paper N. 52 – 2014, at 53 (Nov. 2014) [hereinafter *Working Paper N. 52 – 2014*] (identifying eleven European countries with patent boxes).

[14] *See, e.g., Working Paper N. 52 – 2014*, at 5 (Nov. 2014) ("Tax benefits applying to income from innovation (mostly patent boxes) are proliferating. At the moment of writing, eleven EU member states offered corporate tax reduction for income resulting from to [*sic*] intellectual property."); JCX-51-15, at 46 ("Policymakers have also pursued intellectual property regimes under the premise that the location of legal entitlements to intellectual property influences where companies make investments related to that intellectual property.").

by the European Union as potentially “harmful” tax practices.[15] In February 2015, however, a consensus was reached, which in general terms states that patent boxes are permissible if there is a nexus between the tax benefit provided by a country and research performed within that country, even if the tax benefits extend to the income derived from the intangible and not just the performance of research.[16] Now that a clear consensus has been reached, additional countries (such as Ireland and Italy) may be expected to adopt such incentives, and the existing incentives may be expected to target more directly the relocation of research operations to those countries.

The combination of aggressive source taxation of U.S. multinationals with new tax incentives to relocate their research personnel abroad put further pressure on the U.S. tax system and present a compelling case for addressing at least some aspects of international tax reform now. The most effective way to address these challenges would be comprehensive U.S. tax reform, in which the United States brings its corporate income tax rate, as well as its approach to taxing foreign income, into closer conformity with that of its major trading partners. It is well known that the U.S. corporate income tax headline rate is the highest in the OECD, and approximately 15 percentage points above the OECD median.[17] While effective rates of tax vary by industry and some industries bear lower effective tax rates, statutory rates do matter to companies in making investment decisions.[18]

Although comprehensive tax reform should remain the ultimate goal, the recent pressures that are being exerted on U.S. companies as a result of the BEPS Project and foreign patent box regimes can and should be addressed now, through a subset of measures that can be accomplished in advance of comprehensive international tax reform. As discussed below, the adoption of an innovation-friendly exemption system for taxing foreign income, and the adoption of a U.S. innovation box, could be taken as first steps towards more comprehensive tax reform.

In this regard, the recent examples of the United Kingdom and Japan are instructive. Both countries adopted an exemption system first, and then lowered their corporate income tax rate. The United Kingdom adopted an exemption system in 2009, and it followed up with reductions to its corporate tax rate in 2011 and then additional rate cuts.[19] Between the adoption of an exemption system in 2009 and 2015, the United Kingdom’s corporate tax rate has

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[15] *See Action 5 Deliverable*, at 55–56 (Sept. 2014) (“The current review of member country regimes commenced in late 2010 with the preparation of a preliminary survey of preferential tax regimes in member countries, based on publicly available information and without any judgment as to the potential harmfulness of any of the regimes included.”).

[16] *See* OECD, *Action 5: Agreement on Modified Nexus Approach for IP Regimes* (Feb. 2015).

[17] *See* Joint Comm. on Tax’n, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises*, JCX-90-14, at 38 (2014).

[18] *See id.* at 38–39.

[19] *See JCX-51-15*, at 39; PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD*, at 6 (2013) [hereinafter *Territorial Tax Systems Report*].

fallen from 28 percent to 20 percent.[20] Japan also adopted an exemption system in 2009 and started to reduce its corporate income tax rate in 2013.[21] Between 2012 and 2015, Japan's corporate tax rate has fallen from 39.54 percent to 32.11 percent, and the Japanese government hopes to reduce it below 30 percent.[22] Other countries, such as Spain and New Zealand, have followed a similar pattern.[23] As these examples illustrate, adoption of an exemption system for the relief of double taxation can be a first step towards rate reduction, and changing the system for relieving double taxation does not present an obstacle to further reform.

Adoption of an exemption system would help to address the increased risk of double taxation stemming from the BEPS Project. As discussed, U.S. companies are confronting increasingly aggressive assertions of taxing jurisdiction by foreign countries, which now use the BEPS "stateless income" argument as a pretext for taxing profits that are either subject to current U.S. taxation or to residual U.S. taxation upon repatriation. There is considerable concern that these assertions will result in foreign taxes for which no U.S. foreign tax credit will be allowed by the IRS, resulting in economic double taxation.[24] This outcome would create a serious competitive disadvantage for U.S. companies operating in foreign markets.

The adoption of an exemption system would help to address these concerns by mitigating the risk of international double taxation. Under an exemption system, foreign taxes imposed on active income would no longer be creditable against U.S. income taxes, as they are under the current system. Because foreign active income would be wholly or partly exempt, however, there would be no threat of current or residual U.S. taxation of the same income.[25] Although this solution will not prevent taxation by multiple foreign taxing authorities, it would at

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[20] *See JCX-51-15*, at 39; *Table II.1. Corporate Income Tax Rate,* OECD STAT EXTRACTS (June 22, 2015), http://stats.oecd.org/Index.aspx?QueryId=58204.

[21] *See id.* at 39; *Territorial Tax Systems Report*, at 5.

[22] *See JCX-51-15*, at 39; *Table II.1. Corporate Income Tax Rate,* OECD STAT EXTRACTS (June 22, 2015), http://stats.oecd.org/Index.aspx?QueryId=58204; Tetsushi Kajimoto and Antoni Slodkowski, *Japan's Abe Unveils Plan to Cut Corporate Tax Rate to Spur Growth*, Reuters (June 13, 2014, 8:06 AM), http://www.reuters.com/article/2014/06/13/us-japan-economy-abe-idUSKBN0EO0K320140613.

[23] *See id.* at 39; *Territorial Tax Systems Report*, at 5–6.

[24] In 2013, the Supreme Court considered whether a novel income tax imposed by the United Kingdom was eligible for the foreign tax credit. *See PPL Corp. v. Commissioner*, 133 S.Ct. 1897 (2013). Although the taxpayer prevailed in that case, it raises concerns that the IRS might oppose a foreign tax credit for some of the novel taxes imposed in the name of preventing BEPS.

[25] *See* Joint Comm. on Tax'n, *Present Law and Background Related to the Repatriation of Foreign Earnings*, JCX-96-15, at 13 (2015) [hereinafter *JCX-96-15*] ("However, the question of whether the government can credibly commit to a one-time deemed repatriation under the Camp and Administration proposals is less relevant, or irrelevant, because, prospectively, active income earned by CFCs bears little or no residual U.S. tax, so that the stock of untaxed CFC earnings may accumulate slowly over time (if at all). If this is the case, little or no revenue can be collected from another deemed repatriation.").

least ensure that the United States does not also tax the same income. Of equal importance, adoption of an exemption system would lower the significant tax barrier in current law to repatriating foreign profits for investment in U.S. economic activity and job creation, and a properly designed exemption system would help to level the playing field for U.S. companies competing for customers in foreign markets.

If an exemption system were to be adopted, it has long been accepted that a transition rule would be needed to address the treatment of foreign earnings that are already invested abroad.[26] Under current law, those earnings are subject to residual U.S. federal income taxation at the full corporate tax rate of 35 percent. Nevertheless, these earnings typically are invested in foreign operations, joint ventures, and other long-term investments. Because they are indefinitely invested abroad, they are already effectively exempt from U.S. taxation, provided that they are never repatriated. Forced acceleration of a residual tax liability for those earnings, at the full 35 percent corporate tax rate, would cause significant economic disruption, as companies in many cases would be forced to sell business assets to raise the cash necessary to pay the tax. There are other practical barriers to repatriation as well, such as exchange control restrictions and corporate-law limits on distributions. Any transition tax regime should take such factors into account by lowering the applicable tax rate and providing an extended, interest-free transition period for the payment of any transition tax liability. Such a regime also should provide relief for U.S. companies with overall foreign losses, earnings deficits, and other tax attributes that would distort the amount of tax due in the transition period.

The funds generated by the transition to an exemption system relate to the adoption of that system and should be used in designing a system that favors job creation and technological innovation in the United States. Various legislative proposals have been offered regarding the use of tax revenue from the deemed repatriation of foreign earnings, including proposals to tax those earnings now for spending unrelated to tax reform.[27] Without challenging the validity of the goals sought by those proposals, they would amount to a tax increase on the very companies that already face an increasing risk of foreign taxation and competitive pressure to relocate their operations abroad. The best use of any revenue generated by the move to an exemption system would be to design the system in a way that provides meaningful tax relief to the companies paying the tax and that encourages job creation and the creation of intellectual property in the United States. Once these revenues are received by the Federal Government, their allocation to Highway Trust Fund accounts does not raise international tax policy concerns.

A U.S. incentive for the conduct of innovative research within the United States would be a further, appropriate response to the expansion of foreign research incentives—a U.S.

[26] Joint Comm. on Tax'n, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income*, JCX-33-11, at 13 (2011) ("If the United States adopted a territorial system of taxation, various transition issues would need to be considered. One issue is the treatment of earnings attributable to periods before the enactment of the territorial legislation.").

[27] *See JCX-96-15*, at 8–12 (describing proposals forwarded by former House Ways and Means Committee Chairman David Camp and the Administration).

innovation box comparable to the foreign regimes now endorsed by the BEPS Project. An effective U.S. innovation box would broadly define the type of technology covered, but it would narrowly define the geographic nexus of the underlying research to require that it be performed within the United States. Regarding the scope of the technology covered, neither the existing U.S. research credit nor the innovation box regimes adopted by countries such as the United Kingdom limit their scope to patented technology only.[28] A narrowly defined, patent-only box would raise complex allocation issues and might exclude innovative research for which no patent has been sought for trade secrecy reasons, or for which a patent has been applied but not granted, or for which a patent has been granted but has subsequently expired. In terms of geographic scope, by contrast, the U.S. innovation box could be limited to research activities conducted within the United States in order to encourage retention of high-skilled jobs in the United States.

Neither an exemption system nor an innovation box are complete solutions, but they would serve as important first steps towards comprehensive international tax reform and would serve as an important legislative response to recent international developments. Thank you again for inviting me to present my views to the Committee on these important subjects.

[28] *See JCX-51-15*, at 42–44.