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Hearing on the OECD Base Erosion and Profit Shifting (BEPS) Project

Good morning, Chairman Boustany, Ranking Member Neal, and Members of the Committee. It is a pleasure to appear before you today to discuss the OECD's project on base erosion and profit shifting (BEPS) project and its effects on the U.S. economy.

In 2013, at the request of the leaders of the G-20 nations, the OECD initiated the BEPS project to address the flaws in the international tax system that allowed multinational corporations to shift profits—but not corresponding business operations—from high-tax to low-tax countries. This idea of aligning profits with value creation was entirely consistent with tax reform efforts of the chairmen of the tax-writing committees who at the time who stated: "We'll make sure that companies can't avoid paying tax on income they earn in the U.S. by pretending that they earned it in an overseas tax haven" [2]

Now that most of the BEPS project is completed there is a great deal of commentary about how foreign governments, acting on the OECD's recommendations, will begin taxing profits currently being booked in tax havens.[3] To the extent BEPS principles are implemented, it is likely that the foreign tax burden on U.S. multinationals will rise—especially for those multinationals with lots of intellectual property.

With the release of the check-the-box regulations by the Treasury Department in 1996 it became much easier for U.S. multinationals to reduce their foreign taxes by shifting profits from

[1] The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient. tax code should minimize its role in the economy by rechanneling the revenues devoted to tax breaks into lower rates.
[2] Dave Camp and Max Baucus, "Tax Reform Is Very Much Alive and Doable," *Wall Street Journal*, April 7, 2013.
[3] Mindy Herzfeld, "U.K. Leads on BEPS Implementation While U.S. Dithers," *Tax Notes International*, Nov. 30, 2015.

countries where they conduct most of their business into tax havens.[4] The BEPS recommendations that align taxable profits with value-creating business operations have the potential to take much of the benefit out of this type of check-the-box tax planning. In the 1990s when Treasury wanted to repeal check-the-box regulations[5] many in Congress and the business community questioned why the United States should have rules that help foreign governments collect taxes on U.S. multinationals. Similarly, many are now asking why the United States should support the BEPS project that will help foreign governments collect taxes on U.S. multinationals.

The Economics of Economic Substance

Before discussing how the United States should respond to what some call a "revenue grab" by non-tax haven foreign governments, we should take a moment to discuss another aspect of the BEPS project that also has important economic implications for the United States.[6] Here we are not so much talking about the effect of BEPS principles on competitiveness of U.S. multinationals but about the effect of BEPS principles on the location of multinationals' business operations.

From the start of the BEPS project the focus has been on preventing artificial profit shifting, that is, the shifting of profit achieved by related-party loans, related-party risk shifting contracts, the relocation of rights to intangible property, and adjustment of transfer prices. Through this elaborate "supply chain restructuring" multinationals have been able to shift taxes from high- to low-tax countries usually without a commensurate shift in employment and tangible assets.

To the extent the BEPS project is successful in aligning taxable profits with real activities there will be less artificial profit shifting, more revenue for governments where economic activities take place, and higher taxes on multinationals. But that is not the end of the story. Where before multinationals could lower their taxes with clever tax planning that had minimal impact on real activities, they will now be required to shift jobs and capital investment to low-tax countries to cut their tax bills. With the implementation of BEPS principles, the problem of large tax rate differentials will be much less about cross-border loss of revenue and much more about cross-border shifting of jobs and capital spending.

In general, efforts by tax administrators to require more economic substance—for example, to prevent tax shelter transaction—is widely considered to be good tax policy. What is often forgotten is that adding friction to aggressive tax planning can have the unfortunate side effect of increasing the economic distortions of taxation.[7] In the context of international tax planning, requiring economic substance means shifting real business operations to low-tax countries in order to justify booking profits in those countries. Therefore, requiring alignment of economic activities and taxable profits can either attract or drive away investment.

[4] Treasury Decision 8697.
[5] Notice 98-11.
[6] *Wall Street Journal* editorial, July 23, 2013.
[7] Daniel N. Shaviro, "Corporate Tax Shelters in a Global Economy: Why They Are a Problem and What We Can Do About It," American Enterprise Institute monograph, 2004.

Countries with low tax rates and with substantial economies that are platforms for real investment—countries like Ireland, Singapore, Switzerland, and the United Kingdom—are likely to be winners.[8] Gains to these countries will come at the expense of high-tax countries that will lose jobs and investment. With a combined federal-state tax rate of 39 percent the United States is particularly at risk.

Heightened Tax Competition

The OECD's BEPS project is telling governments that profits must be aligned with substantial value creation. If these principles are adopted, we could be entering a new era where rate differentials take on heighted significance. The likely response by foreign parliamentary governments that can more easily change their tax laws and are willing to pursue a tax competition agenda will be further reductions in their corporate tax rates. Thus, the already problematic economic effects of a high U.S. corporate tax will be compounded by rate cuts of foreign governments responding to BEPS. Reducing the corporate tax rate has always been a top priority of economic policy. The BEPS project has raised the stakes.[9]

The critical question is how do we pay for a lower corporate tax rate?

The tepid response to former Ways and Means Committee Chairman Camp's prodigious tax reform efforts demonstrates the political obstacles to tax reform. It has been five years since Simpson-Bowles Commission put tax reform on the front burner. But since then there has not been one tax reform proposal that has come close to coming up for a vote in either the House or Senate tax-writing committees.

That's the politics of tax reform. Then there are the economics of tax reform. It is entirely possible that any revenue-neutral corporate tax reform that rolls back investment incentives to pay for a corporate lower rate will impede--not promote--economic growth. Unlike 1986, there are not many big-money tax breaks available to pay for a corporate rate cut, and a substantial portion of those tax expenditures that could be repealed to finance a rate reduction are not loopholes but incentives for domestic investment.

At the top of list of "usual suspects" to pay for a corporate rate cut is a reduction in depreciation allowances. Unfortunately, the positive growth effects of a rate cut (which rewards old and new capital) would be more than offset by negative effect of slower of capital recovery (which is borne entirely by new investment). If on top of that you include capitalization of research expenditures and cuts to the research credit, as proposed by Chairman Camp, you have a tax reform that penalizes capital formation with the heaviest burden on domestic manufacturing.

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[8] In July of 2015 the British government announced its intention to reduce the United Kingdom's corporate tax rate to 19 percent in 2017 and to 20 percent in 2020.

[9] In a very recent article Daniel A. Witt makes the same point: "Another unintended consequence of BEPS is that the competition for real economic activity (e.g., physical plants and production sites) will increase, and likely lead to continued downward pressure on corporate income tax rates." (*Tax Notes International*, Nov. 30, 2015, p. 759.)

Any cut in the corporate tax rate is a welcome development. So if the Congress can find a way to cut the U.S. rate from 35 to 30 percent or through base broadening reforms that do not reduce investment incentives it should not let the perfect be the enemy of the good. But this still leaves the United States with a clunky corporation tax that is poorly suited to the modern international economy.

Clearly if we want a tax reform that will substantially improve America's competitiveness we must begin to think differently. We must look beyond cuts in corporate tax expenditures as source of revenue to pay for corporate rate cuts. Revenue-neutrality is not a useful guiding principle for 21st century corporate tax reform. For all its merits the Tax Reform Act of 1986 is not a model for our next tax reform. We must begin to think about replacing revenues from our most economically damaging tax with revenue from new sources.

One option would be for the United States to follow the example of other nations that have cut their corporate tax rates and adopt a value added tax. A reduction in the corporate tax rate to 15 percent could be paid for a 5 percent value added tax. This would greatly enhance the competitiveness of the U.S. economy because the revenue from the capital-repelling corporate tax would be replaced with a highly efficient consumption tax. Senate Finance Committee member Benjamin Cardin, D-Md., has proposed that the revenues from a federal value-added tax with a 10 percent rate be used to pay for large cuts in individual and reduction in the corporate tax rate to 17 percent.

Tax Investors, Not Investment

Another straightforward and economically intriguing concept is a tax reform that shifts tax away from business entities and onto investors. The main advantage of shifting taxes on capital to the personal level stems from differences in cross-border mobility. Investors are less mobile than investment. Most people are unwilling to uproot families, leave friends, and adopt a new culture just to save taxes. For a profit-maximizing corporation, however, an international relocation is just a matter of dollars and cents. And with improved communications the costs of spreading business operations across the globe are decreasing.

The idea that we must shift taxes on corporations to taxes on investors is gaining increasing acceptance among policy experts on both side of the aisle.

In a 2010 paper economists Rosanne Altshuler, Benjamin Harris, and Eric Toder explored the possibility of returning the top dividend and capital gains rates to their pre-1997 level of 28 percent. They made several interesting findings: First, most OECD countries have moved in the opposite direction of the United States and have raised shareholder tax rates while lowering corporate rates. Second, because the cross-border mobility of individuals is less than that of corporations, such a change would reduce tax distortions in economic decision-making. Third, because the burden of corporate taxation is believed to increasingly fall on labor, a shift in tax from corporations to shareholders would increase the progressivity of the tax system.[10]

[10] "Capital Income Taxation and Progressivity in a Global Economy," *Virginia Tax Review*, 2010, p. 355.

In 2011 testimony before the Senate Finance Committee, Professor Michael Graetz of Columbia Law School, a former Treasury official, stated that the Treasury Department traditional view of favoring reductions in shareholder taxes over reductions in corporate taxes has not withstood the test of time because of the "internationalization of the economy." Graetz told the committee that "It is far easier and, I believe now better tax policy, to collect income taxes from individual citizens and resident shareholders than from multinational business enterprises." He then suggested that Congress consider a cut in the corporate rate to 15 percent and a tax increase on individuals in the form of a withholding tax on corporate shareholders and bondholders

And just last week James Pethokoukis of the American Enterprise Institute wrote: "Perhaps it is time for a new approach, with one economically obvious reform being a shift of corporate income taxation from the corporate level to that of the individual shareholders." Similarly, Alan Viard, also at the American Enterprise Institute, has stated: "We need to base our tax on where the stockholders live. We should give up this idea of taxing income at the corporate level, and instead say American shareholders should pay tax every year at full ordinary income rates on their dividends and their capital gains from any company no matter where the company is chartered or managed or where it earns its profits, and that tax should apply regardless of whether the stockholders sold the stock or not."[11]

BEPS and International Tax Reform

In the prior section I argued that BEPS provides extra motivation for Congress consider new and bold approaches to domestic corporate tax reform that differ considerably from the approach taken by Chairman Camp last year. The best way for the United States to respond to BEPS is to lower its corporate rate and to maintain or even expand well-designed investment incentives. On the international side—although many details that are yet to be settled--the basic thrust of the Camp approach to territorial taxation, including all of its strong anti-base erosion provisions, still seems correct.

First and foremost, we need to banish lock-out from our international tax rules. I am skeptical of the magnitude of economic benefits that some claim will arise from removing the tax penalty from repatriation of foreign earnings. Nevertheless, there are negative consequences of lock out.[12] And the problem is easily solved by imposing domestic tax (if any) on foreign profits when profits are earned instead of when they are paid as dividends to the U.S. parent.

We also need tough earning stripping rules. It is common practice for foreign-headquartered multinationals to shift income out of the United States by paying interest on related-party loans from foreign affiliates. Because U.S. controlled foreign corporation rules prevent this, the ability to strip earning is a major a motivation for U.S. headquartered companies to invert. To encourage foreign headquartered multinationals to invest in the United States we should replace tax benefits for debt with tax incentives for capital expenditure.

[11] James Pethokoukis, "What to Do About US Firms Moving Overseas to Pay Lower Tax Rates?" November 23, 2015. Includes quote from Alan Viard.
[12] Martin A. Sullivan, "The Economic Case for Unlocking Foreign Profits, *Tax Notes,* July 2, 2012, p.7.

Interestingly, if the United States fully embraced the BEPS principle of aligning profits with value creation, there would be less need for the tough anti-base erosion rules in Chairman Camp's proposed reform or for a minimum tax as proposed by President Obama. This would be a welcome development because it is difficult to design such rules that are both administrable and effective.[13]

Finally, the Camp proposal to apply a one-time tax on the stock of accumulated foreign earnings (so called "deemed repatriation") should not only be fully embraced, it should be expanded. Under the Chairman Camp's plan unrepatriated foreign earnings currently held as cash would be taxed at 8.75 percent and other unrepatriated earnings invested in active business would be taxed at 3.5 percent. The Joint Committee on Taxation estimated this proposed would raise $170 billion over ten years. From an economic perspective, this is about the most efficient tax possible—even better than a consumption tax—because as a tax on old capital it does not affect incentives to invest on a going forward basis. Therefore, in order to pay for rate cuts and tax incentives that would promote domestic capital formation and job growth, Congress should give high priority to the a deemed repatriation proposal with rates considerably higher than those proposed by Chairman Camp.

Thank you for the opportunity to discuss these important issues. I am happy to answer any questions that the committee may have.

[13] Martin A. Sullivan, "Designing Anti-Base-Erosion Rules," *Tax Notes*, April 22, 2013, p. 347.