

Testimony of Michelle Hanlon
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Chairman Brady, Ranking Member Levin, and distinguished members of the Committee, I appreciate the opportunity to participate in this hearing. I am a chaired professor at the Sloan School of Management at the Massachusetts Institute of Technology. I teach and do research on financial accounting and taxation. I am an editor of the *Journal of Accounting and Economics*.¹

At 35% the United States has one of the highest statutory corporate tax rates in the world. But this was not always the case. In 1988, after the Tax Reform Act of 1986, the U.S. statutory corporate tax rate was five percentage points lower than the OECD average. Since that time, however, other countries have significantly reduced their corporate income tax rates. Indeed, according to the OECD, the combined U.S. and average state corporate income tax rate (at 39%) is over 14 percentage points higher than the average for the other 33 OECD member countries (at 24.6%).² A specific example is the UK which has a corporate income tax rate of 20% and is reducing it further to 18%. In addition to the high statutory tax rate, the U.S. has a worldwide tax system under which profits earned abroad face U.S. taxation (with allowed foreign tax credits) when brought back to America.³ While worldwide taxation was at one time more common around the globe, much has changed. Currently, all of the other G7 countries and 28 of the other 33 OECD member countries have adopted territorial tax systems that allow active business income to be repatriated without (or with very little) additional home country tax. Indeed, in 2009 both the UK and Japan moved to territorial tax systems. The United States has chosen to retain worldwide taxation and a high statutory tax rate even though both policy choices are out of step with much of the rest of the world. The combination of the high U.S. corporate tax rate and the worldwide tax system has led to negative economic consequences for the United States.

¹ Some portions of this testimony are taken from, or are very similar to, points I made in an op-ed in the *Wall Street Journal* published on June 11, 2014.

² OECD, Tax Database, Table II.1. <http://stats.oecd.org/index.aspx?Queryid=58204>

³ Some foreign earnings are taxed currently (without deferral) in the U.S. under what is known as subpart F.

In order to compete and/or maximize shareholder value, U.S. multinational corporations employ a type of do-it-yourself territorial tax system by accumulating foreign earnings rather than repatriating the earnings and paying the U.S. taxes. The result is that a company's immediate cash tax burden is lower because the incremental U.S. tax is not required to be paid until the earnings are repatriated to the United States. Leaving the earnings in the foreign subsidiaries allows a U.S. multinational to more effectively compete for non-U.S. investments. In a simplified example, assume a foreign subsidiary of a U.S. parent earns \$10 million and pays \$2 million in local tax to the foreign jurisdiction. The remaining earnings could be repatriated to the U.S. parent or left in the foreign subsidiary. If repatriated, there would be an additional U.S. tax of \$1.5 million ($[\$10 \text{ million} \times 35\% \text{ U.S. rate}] - \$2 \text{ million credit for foreign tax}$). Thus, if left in the foreign subsidiary, there would be \$8 million to invest, but if repatriated to the U.S., there would only be \$6.5 million to invest (less if state income tax is imposed). In contrast, a UK company, for example, could repatriate the \$8 million back to the UK and then invest the full \$8 million in their home country (or they could change their mind and invest the full \$8 million in a foreign country depending on the investment opportunities). The U.S. corporation has much less mobility of capital – if they repatriate the earnings, they have to pay the U.S. tax leaving less for future investments. Also, not repatriating active foreign earnings often reduces the company's reported effective tax rate for financial accounting purposes because companies are not required to accrue the incremental U.S. tax on their financial statements if management does not plan on repatriating those earnings to the United States. Thus, reported net income to shareholders is higher, all else constant.⁴

What all this means is that corporate managers have strong incentives to leave foreign earnings in their foreign subsidiaries because it increases cash flow, puts them closer to parity with non-U.S. companies for investment opportunities, and increases reported accounting earnings. U.S. multinational corporations are estimated to hold significantly more than \$2 trillion in unremitted foreign earnings, a substantial portion of which is in cash. This is cash that cannot

⁴ See Graham, Hanlon, and Shevlin (2011) for a discussion and tests of the effect of the financial accounting rules. Note that leaving the foreign earnings in foreign subsidiaries and designating the foreign earnings as permanently reinvested lowers the financial accounting effective tax rate for a U.S. company but there is an unrecorded liability that the company would have to pay should they repatriate the earnings in the future. Thus, the effective tax rate for a U.S. company is not directly comparable to the effective tax rate for a company in a country with territorial taxation because the former has an unrecorded potential liability and the latter does not.

be reinvested in the U.S. business or given to shareholders. The lockout of foreign earnings and cash leads companies to borrow more in the U.S. to fund domestic operations and return value to shareholders. This borrowing leads to additional leverage on balance sheets and additional deductions on corporate tax returns. Several companies have stated publicly that they borrow in the U.S. instead of repatriating foreign earnings. For example, Cisco Systems, Inc. in their financial statements for their fiscal year 2015, reports that they have not accrued U.S. taxes on \$58 billion in unremitted foreign earnings. The company's balance sheet shows (worldwide) cash and securities of over \$60 billion. Cisco has at the same time issued large amounts of corporate bonds in recent years increasing their debt levels. Indeed, they report short and long-term debt of over \$25 billion dollars on their fiscal 2015 balance sheet.⁵ For comparison, ten years ago, at the end of their fiscal year 2005, Cisco had "only" \$6.8 billion in permanently reinvested foreign earnings, \$7 billion in cash and securities, and zero interest-bearing debt on their balance sheet. Cisco is not alone in the accumulation of cash in foreign subsidiaries and the simultaneous issuance of debt in the United States.

My co-authors and I did a survey of corporate tax executives in 2007. We found that 44% of the companies that responded said they borrowed in the U.S. to fund domestic operations rather than repatriate foreign earnings to the United States (Graham, Hanlon, and Shevlin (2010)). Similarly, in another study, Albring (2006) examines 156 U.S. manufacturing companies and finds that as a company's repatriation tax cost increases, the company is more likely to borrow in the U.S. than repatriate foreign earnings. The global changes in terms of the reduction of corporate tax rates in other countries and fewer countries retaining a worldwide tax system have increased competitive pressures for such behavior and will only continue to increase these pressures on corporate management. The insanity of the U.S. tax system is clear when one simply considers the amount of locked-out cash and the effects on corporate debt policy.

While the cash holdings and leverage effects are very troubling, even more concerning may be the consequences in the market for corporate control. The evidence in the academic research suggests that merged entities are less likely to locate their parent company in a country with a worldwide tax regime and that the U.S. international tax system leads to U.S. companies

⁵ Cisco's debt is rated at less than AAA (the top rating) in recent years. (The same is true for Apple, Inc.)

being less competitive when trying to acquire other companies. For example, Huizinga and Voget (2009) examine cross-border mergers and provide evidence that the location of the parent firm after a cross-border merger is less likely to be in a country with worldwide taxation.⁶ Essentially, the international tax regimes of the countries of the merging companies affect the organizational structure after a merger deal (e.g., the U.S. is less likely to attract the location of the parent following a merger with a foreign company from a territorial jurisdiction). A more recent paper by Feld, Ruf, Scheuering, Schreiber, and Voget (2013) extends and builds on these results by testing the effect of changing to a territorial system from a worldwide system using the experience of the UK and Japan. The authors conclude that taxes on repatriated income (i.e., a worldwide tax system) reduces the competitiveness of companies in the market for corporate control. Specifically, the authors find evidence consistent with a lower likelihood of an acquirer in a cross-border deal being from a worldwide tax country relative to a country with a territorial regime. They also find that the larger the home country tax rate the larger the impact and show that the effect of Japan's change to a territorial tax system (when the rate was 40%) was greater than the UK's change (when the rate was 28%). The results in this paper suggest that a U.S. switch to territorial taxation would increase the number of cross-border mergers where the U.S. company is the acquirer rather than the target.

Other studies specifically examine the effect of locked-out earnings and cash of U.S. multinational corporations on M&A activity. For example, in a recent study by Bird, Edwards, and Shevlin (2015), the authors find that the likelihood of a U.S. target being acquired by a foreign firm increases with the amount of locked-out earnings. The authors find that this relation is stronger when the foreign acquirer is from a country with a territorial tax regime. While there

⁶ A variety of statistics are available regarding the location of corporate headquarters as well. The Business Roundtable issued a report in the fall of 2015 entitled "Tax Reform: Advancing America in the Global Economy." The report states that in 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 1985, the top 20 still included 13 American companies. In 2014, the latest data show just six American companies (rankings are from the Global Fortune 500 for various years). Of the 14 non-U.S. companies in the top 20 list, 10 were headquartered in countries that use territorial tax systems. Of the remaining four, three were state-owned companies headquartered in China, and the other was headquartered in South Korea, which has a 24.2 percent combined national and subnational tax rate. According to the report, within the OECD, 90 percent of the non-U.S. companies in the Global Fortune 500 in 2014 were headquartered in countries that use territorial tax systems, whereas in 1995 only 27 percent of the non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries (2014 Global Fortune 500 list available at <http://fortune.com/global500/> and the 1995 Global Fortune 500 list available at <http://fortune.com/global500/1995/>).

may be several effects at work here, the hypothesis in the study is that the foreign acquirer may be able to access some of the historic and future foreign earnings without as much U.S. tax liabilities and thus have a bidding advantage. There are also several studies that show that U.S. companies with large amounts of cash held in their foreign subsidiaries are more likely to purchase foreign companies than domestic companies and these acquisitions of foreign companies are less value enhancing than other acquisitions (Hanlon, Lester, and Verdi (2015), Edwards, Kravet, and Wilson (2016)). Thus, companies are both stockpiling cash and investing (seemingly poorly) in foreign locations because the U.S. tax policy impedes repatriation. Possible explanations for the (poor) foreign investment is that the cash burns a proverbial hole in managers' pockets or that the high cash balances make them an attractive takeover target (a la Bird et al., described above) so they spend the foreign cash to avoid being taken over.

Finally, the transactions that have grabbed the media headlines are what are known as inversions where U.S. corporations reincorporate as foreign companies through cross-border mergers. Without question, inversions are something we all should be concerned about for a variety of reasons. One reason is the potential for so-called earnings stripping where the newly formed foreign company reduces the U.S. tax base by making deductible payments from the U.S. entity to the new foreign parent. However, the main reason we should be concerned is because these deals say a lot about the antiquated nature of our tax code.⁷ Despite the sensationalism of inversions, I think it is important to maintain the focus on the broader effects of the U.S. tax system and what can be accomplished with tax reform. It would be better to reform our international tax regime more completely rather than enacting piecemeal legislation that is solely intended to increase the U.S. tax revenue from existing companies. However, in efforts to prevent inversions the U.S. has put targeted legislation in place that imposes penalties when the former shareholders of the U.S. company own too high of a share of the merged entity (e.g., the 80% and 60% thresholds). This seems to push managers into more substantive transactions that give more control to the shareholders of the foreign merger partner (relative to before there was anti-inversion legislation). These are possibly more harmful deals for the U.S. economy.⁸

⁷ For example, the high U.S. tax rate incentivizes the so-called earnings stripping.

⁸ A recent study by Rao (2015) is consistent with this conjecture. The author is cautious and describes the evidence as observational and not causal because of empirical research design issues (for example, endogeneity and time trend concerns). However, the evidence is consistent with inverting firms locating more employees abroad after an

Continuing to focus on legislation that prevents inversions (including targeted legislation to limit so-called earnings stripping) will not correct the bigger problem that corporations do not want to be domiciled here because of our high rate, worldwide tax system, and complicated tax code (nor will such legislation entice entrepreneurs to start businesses here). In summary, there are many determining factors, both tax and non-tax, in large, cross-border M&A transactions no matter whether the deal is an inversion, a friendly merger, or hostile takeover. But in all of these cases with the current tax policies of the U.S., the decision of where the merged entity should be located for tax purposes is clear: not the United States. We need to reform the U.S. corporate tax system to attract businesses and economic activity to our shores.

Beyond the lower corporate income tax rates and moves to territorial tax regimes, many other changes are happening around the world. For example, the OECD Base Erosion and Profit Shifting (BEPS) project is affecting the ways that other governments compete for and tax cross-border investment. It is hard to predict the economic effects of such changes and the economic effects of the interactions of, and responses to, these changes. However, let's consider just one example of the changes brought about by the BEPS project. Many countries have enacted or are contemplating innovation or patent box tax policies (e.g., the 10% UK patent box). An innovation box can take several forms, but in general it is a tax policy that applies a lower tax rate to income attributable to patents and other intellectual property associated with innovation. The idea behind such a policy is to attract mobile income. The OECD as part of the BEPS project has put guidelines in place that essentially will require nexus, meaning some association to economic activity (e.g., research and development located in the jurisdiction) before the income can be taxed at the lower rate of the innovation box. If the U.S. does nothing in terms of tax reform, one possible outcome of these innovation box policies is that U.S. companies will move (or keep) patents in the jurisdictions with patent box regimes in order to obtain lower tax

inversion relative to non-inverting firms. Furthermore, in a comparison of deals before and after the 2004 legislation that required more substantive transactions for the tax benefits of the transaction to be retained, Rao (2015) reports evidence consistent with the employment changes being concentrated in the post-2004 transactions. Rao includes transactions as inversions that meet the definition of an inversion in the tax code as well as transactions that do not meet the definition of an inversion in the tax code. The intent is to include transactions that obtain the tax benefits of an inversion but are structured to avoid the classification of inversion. More research is needed on employment effects before more definitive conclusions can be made.

rates (on the order of 5%-15%). Moreover, in order to meet the nexus requirements agreed to by participants in the OECD BEPS project, U.S. companies will have to move some R&D activities (jobs) as well. This type of real response may take some time to complete, but if the U.S. does not act to make its tax code more competitive, such a response, at least to some extent, seems inevitable.

In summary, the United States is currently an outlier with a worldwide tax system that taxes the operating income of foreign subsidiaries when repatriated at a 35 percent federal rate (foreign tax credits are allowed). This system leads U.S. companies to 1) leave more cash in foreign subsidiaries, 2) to borrow more in the U.S., 3) be at a competitive disadvantage relative to foreign competitors from territorial jurisdictions, 4) use foreign cash to invest more in foreign locations than U.S. locations, and 5) to engage in merger deals with, or be acquired by, foreign companies who have a tax advantage. It is true that there are many non-tax reasons businesses want to locate in the United States. The innovation culture, strong labor pools, great universities, excellent research environment and culture, (relatively) secure and safe financial institutions, the best capital markets in the world, and strong corporate governance make the U.S. a great nation and a very desirable place to do business. But having these competitive non-tax factors is not an excuse for retaining an outdated and uncompetitive tax code. Moreover, the world is changing. The non-tax advantages of locating a business in the United States are not as strong as they once were, and other countries are working hard to use their tax laws to compete. As mentioned above, the UK has significantly lower corporate tax rates, a territorial tax system, and a patent box. In addition, they have many similar non-tax factors when compared to the U.S. such as an educated labor pool and secure financial institutions. When considering the U.S. tax regime, it is imperative not to benchmark current policies to those of the U.S. in the past, but rather to the tax systems of other countries that are competing for business activity and jobs right now and in the future.

Thank you again for inviting me to participate in this hearing. I look forward to your questions.

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