AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

TAX REFORM AND FOREIGN INVESTMENT IN THE UNITED STATES

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

JUNE 23, 2011

Serial No. 112–SRM3

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
72–279 WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

PAT TIBERI, Ohio, *Chairman*

PETER ROSKAM, Illinois
ERIK PAULSEN, Minnesota
RICK BERG, North Dakota
CHARLES BOUSTANY, Louisiana
KENNY MARCHANT, Texas
JIM GERLACH, Pennsylvania

RICHARD E. NEAL, Massachusetts, *Ranking Member*
MIKE THOMPSON, California
JOHN B. LARSON, Connecticut
SHELLEY BERKLEY, Nevada

JON TRAUB, *Staff Director*
JANICE MAYS, *Minority Staff Director*

CONTENTS

TAX REFORM AND FOREIGN INVESTMENT IN THE UNITED STATES

THURSDAY, JUNE 23, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:02 a.m., in Room 1100, Longworth House Office Building, the Honorable Patrick Tiberi [Chairman of the Subcommittee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

Chairman Tiberi Announces Hearing on Tax Reform and Foreign Investment in the United States

Thursday, June 23, 2011

Congressman Pat Tiberi, (R–OH), Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the importance of foreign direct investment (FDI) to the U.S. economy and how tax reform might affect foreign-headquartered businesses that invest and create jobs in the United States. **The hearing will take place on Thursday, June 23, 2011, in Room 1100 of the Longworth House Office Building at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

Foreign direct investment plays an important role in the U.S. economy. According to the Commerce Department, FDI increased to $194.5 billion in 2010 after plummeting to $134.7 billion in 2009 as a result of the economic downturn. (In 2008, FDI reached an all-time high of $328.3 billion.) U.S. subsidiaries of foreign-based companies employ 5.6 million American workers—roughly 5 percent of the U.S. private sector workforce. Foreign-headquartered companies share many of the same concerns about the U.S. tax system that purely domestic companies raise, such as the relatively high U.S. corporate tax rate. Foreign-based companies also face tax issues unique to their business structure, and some commentators have suggested that there are tax obstacles to additional FDI in the United States.

In 2007, the Treasury Department published a study on inbound transactions that covered earnings stripping, transfer pricing, and eligibility for tax treaty benefits. Among other findings, the study determined that there was not conclusive evidence on whether U.S. subsidiaries of foreign parents engage in earnings stripping. Treasury recommended that policymakers continue examining the question as better information becomes available.

In announcing the hearing, Chairman Tiberi said, **"Foreign direct investment is critical to growing the economy and creating jobs. U.S. affiliates of foreign-based companies often consider themselves American businesses, and share the same concerns about U.S. tax policy as other American businesses, such as the high corporate rate. At the same time, some tax issues are unique to foreign investment, and as part of fundamental tax reform the Subcommittee must examine those issues as well."**

FOCUS OF THE HEARING:

The hearing will focus on the important role that FDI plays in expanding the U.S. economy and creating jobs for American workers. The hearing will explore the tax environment facing foreign investors and foreign-headquartered businesses investing or operating in the United States. It also will examine a number of tax provisions applicable to inbound activity, including (but not limited to) the U.S. corporate tax rate, foreign investment in real property, and the earnings stripping rules of Code section 163(j).

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, July 7, 2011**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman TIBERI. The hearing will come to order. Good morning, everybody, and thank you for joining us this morning for another in a series of hearings on comprehensive tax reform.

As I think everybody by now knows, under the leadership of Chairman Camp the Ways and Means Committee has been working through a full assessment of our Federal Tax Code. And, from the assessment, it is clear the Tax Code stifles job creation at a time when unemployment rates in Ohio and across the country remain well above their historic averages. The goal is tax reform is to reverse this trend. The time is long overdue to write a Tax Code that better incentives job creation in the United States of America.

Today's hearing highlights an important contributor to our economy: foreign companies who directly invest in the United States of

America. Their investment is critical to growing the economy and creating jobs. Over the past 10 years, affiliates of foreign companies have employed between five and six million workers in America.

This month the Administration released two reports affirming the importance of foreign direct investment. I agree, and look forward to working with the Administration to eliminate the regulatory barriers standing in the way of creating greater foreign investment.

Chairman Camp requested that the Select Revenue Measures Subcommittee further examine inbound issues raised in prior tax reform hearings. We have heard concerns from U.S. businesses about the Tax Code. Many U.S. affiliates of foreign-based companies view themselves as American businesses, rather than foreign businesses. Today's hearing will provide them the opportunity to share their concerns.

Today's hearing will also examine tax rules specific to foreign investment, including earnings stripping and transfer pricing. The effectiveness of those rules in preventing foreign companies from using the Tax Code to create a competitive advantage over domestic companies is the subject of great debate.

Finally, I look forward to examining the impacts of the Foreign Investment and Real Property Tax Act. With talk of a double-dipper session increasing the availability of capital from foreign investors is a common-sense step to strengthening the U.S. commercial real estate market. Last year, Congressman Crowley introduced legislation with me to address this issue. I understand similar legislation is in the works this year, and I applaud those bipartisan efforts.

I want to welcome all our witnesses to today's hearing, and look forward to their testimony. With that, I yield to our ranking member, my friend from Massachusetts, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. And I want to thank you again for calling this important hearing today.

Our committee has been examining the impact of tax reform on U.S. multinational companies. I am pleased to now shift gears, and to focus on the equally important topic of the taxation on foreign-owned companies operating in the United States.

In order to remain competitive in a global economy, foreign investment in the United States is critical. This is especially true during these difficult economic times, when job creation is more important than ever. And foreign-owned companies create jobs here, in the United States. Today these companies employ, as you have noted, over five million Americans, and support an annual payroll of over $400 billion. In my home state of Massachusetts, U.S. subsidiaries of foreign-owned companies have created almost 190,000 jobs.

I was very pleased to hear the announcement by the White House Council of Economic Advisors on Monday that in 2010 foreign direct investment in the United States had increased by 49 percent from the low it reached in 2009. I certainly look forward to hearing today's witnesses discuss how we can continue to encourage foreign investment in the U.S.

Today's hearing will also focus on whether our current tax system favors foreign companies over domestic companies. One of today's witnesses will testify that foreign-owned companies have a significant competitive advantage in the U.S. marketplace over U.S.-owned companies. In my opinion, we should treat foreign and domestic companies equally. That is why I have introduced legislation to close the loophole that allows the use of excessive affiliate reinsurance by foreign insurance groups to strip their U.S. income into tax havens, avoid tax, and gain a competitive advantage over American companies.

But before concluding, I would like to thank the chairman for the bipartisanship that he has developed in offering this hearing. Henry Ford noted that coming together is a beginning, keeping together is progress, and working together offers success. I hope we will continue to work together on tax reform, and we can use this hearing as a model to continue the work that we have witnessed in both the Majority and Minority status that I have had on this subcommittee. I believe that is how we will best achieve success in reforming our tax system.

Thank you, Mr. Chairman.

Chairman TIBERI. Thank you, Mr. Neal. And I concur. I want to thank you for your leadership on this specific issue, and just thank the staff, as well. Both the Republican staff and the Democrat staff worked together on this hearing, and I want to applaud both sides, both staffs, for their hard and diligent work.

I also want to, before we begin, recognize a new member of our subcommittee, hails from the Commonwealth of Pennsylvania, colleague and good friend, Mr. Gerlach. Thank you for joining our subcommittee.

Before we introduce the witnesses for the panel, I ask unanimous consent that all Members' written statements be included in the record.

[No response.]

Chairman TIBERI. Without objection, so ordered. We will now turn to our first panel of witnesses. I want to extend a welcome to Nancy McLernon, president and CEO of the Organization for International Investment; Mr. Alexander Spitzer, senior vice president of taxes for Nestle Holdings; Claude Draillard, Dassault Falcon Jet Corporation, Little Ferry, New Jersey; and Jeffrey DeBoer, president and chief executive officer of the Real Estate Roundtable, here in Alexandria, Virginia.

With that, Nancy, you can begin your testimony. You have five minutes.

STATEMENT OF NANCY L. MCLERNON, PRESIDENT & CHIEF EXECUTIVE OFFICER, ORGANIZATION FOR INTERNATIONAL INVESTMENT, WASHINGTON, D.C.

Ms. MCLERNON. Thank you. Good morning. Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, I want to thank you for the opportunity to testify this morning. I applaud your leadership in holding this timely hearing on the importance of foreign direct investment to the U.S. economy.

I am president and CEO of the Organization for International Investment. OFII is a business association exclusively comprised of

the U.S. subsidiaries of global companies. OFII refers to our members as insourcing companies, due to the jobs these firms insource to the United States.

OFII advocates for fair and non-discriminatory treatment in U.S. law and regulation for these companies and the millions of Americans they employ. Our mission is to ensure that the United States remains the most attractive location for foreign investment and job creation for global companies looking to expand around the world.

This hearing comes at a time when the United States faces serious fiscal challenges at home, and an increasingly competitive global landscape for attracting and retaining investment. And while the United States remains the world's largest recipient of foreign investment, its share of global investment has declined dramatically, from garnering 40 percent of the world's cross-border capital 10 years ago, to about 17 percent now.

The committee's work on fundamental tax reform is vital to ensure that the United States remains the premiere location for global companies to invest. Simply put, America cannot afford to lose more ground in the race for the world's investment.

The U.S. subsidiaries of global companies already play a significant role in America's economy. The chairman and Mr. Neal already talked about the number of jobs. These companies employ over five million American workers, which is about five percent of the private sector workforce. They maintain an annual payroll of over $400 billion, and account for 6 percent of GDP. And while they make up less than one percent of all U.S. businesses, these firms pay a full 17 percent of corporate taxes. And these companies pile billions of dollars in earnings each year back into their U.S. operations, reinvesting over $93 billion, according to the most recent annual data.

Foreign direct investment tends to disproportionately create and sustain high-end jobs for Americans. U.S. subsidiaries pay their employees over 30 percent more than the average company, reflecting the high-scale nature of their scientific, engineering, and manufacturing workforce. And in the hard-hit manufacturing sector alone, U.S. subsidiaries account for 13 percent of the labor force, which is about 2 million jobs.

Annually, foreign direct investment leads to over $40 billion in domestic research and development, accounting for more than 14 percent of America's private sector R&D. And while counterintuitive to some, many globally-based companies have established their American operations as a platform from which to manufacture goods to sell to the world. U.S. subsidiaries produce more than 18 percent of total U.S. exports.

It is worth noting that the vast majority of inbound investment to the United States come from firms headquartered in other developed countries. In 2010, almost 90 percent of inbound investment came from Canada, Europe, and Japan. It is worth noting that for all the headlines it generates, Chinese investment accounts for a minuscule portion of foreign investment in the United States: less than one percent.

In the midst of recent economic challenges, foreign investment has continued to be an engine for job creation and a catalyst for growth throughout the country. For example, at a time when the

unemployment rate is a focus of national attention, Netherlands-based Philips Electronics is working to fill 1,500 job openings across the country. The company already employs over 25,000 people in the United States, including over 1,000 at its manufacturing facility in Highland Heights, Ohio, where they develop, produce, and export high-end medical imaging technologies such as MRI and CT scanners for customers around the world.

Philips also chose to place the global headquarters of its health care division in Massachusetts, and does the vast majority of its worldwide health care manufacturing work in the United States.

However, the competition to attract and retain companies like Philips has never been stronger. Companies today have an unprecedented array of options when looking to expand their business around the world.

OFII sees tax reform as an important opportunity to encourage greater investment in the United States. As American businesses, OFII members share many of the same concerns regarding tax policy as other U.S. companies. Specifically, we believe Congress should give due consideration to three overriding factors.

First, OFII is united with the broader American business community, and its support for reducing U.S. federal corporate income tax. In fact, OFII's annual survey of chief financial officers showed that the corporate tax rate ranked as the policy change that would have the greatest impact on incentivizing investment here.

Second, OFII encourages increasing the certainty, transparency, and reliability of the U.S. tax system to allow for long-term strategic planning.

And finally, most important to this unique slice of the business community, OFII strongly cautions against any proposals that would disadvantage U.S. subsidiaries in their efforts to do business in our market on a level playing field. Such policy would surely impact our ability to attract global investment.

I am pleased to answer any questions you may have, and I look forward to working with this committee and Congress in considering tax reform that will increase investment in the United States. Thank you.

[The prepared statement of Ms. McLernon follows:]

Written Testimony of Nancy L. McLernon

President & CEO

Organization for International Investment

Before the Subcommittee on Select Revenue Measures

Committee on Ways and Means

United States House of Representatives

June 23, 2011

Introduction & Overview

Good morning. Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, I want to thank you for the opportunity to testify this morning. I applaud your leadership in holding this timely hearing on the implications of tax reform on America's ability to attract foreign direct investment (FDI).

My name is Nancy McLernon and I am President and CEO of the Organization for International Investment (OFII). OFII is a business association exclusively comprised of the American subsidiaries of foreign domiciled companies. We advocate for fair and non-discriminatory treatment in U.S. law and regulation for these companies and the millions of hard-working Americans they employ. Our mission is to ensure that the United States remains the most attractive location for foreign investment and job creation for global companies looking to expand around the world.

This hearing comes at a time when the United States is at an economic crossroads, facing serious fiscal challenges at home and an increasingly competitive global landscape for attracting and retaining investment. As both the largest global investor and the largest beneficiary of inbound FDI, the United States plays a critical role in promoting open investment policies both domestically and abroad.

This Committee's work on fundamental tax reform is vital to ensure that the United States remains the premier location for global companies to invest. Simply put, America cannot afford to lose ground in the race for the world's investment.

The Economic Impact of Foreign Direct Investment in the United States

In spite of the historic success of the United States in attracting global investment, the extent to which it plays an integral role in U.S. economic strength and stability is not widely understood. The U.S. subsidiaries of global companies help to foster a diverse and vibrant American business community. Today, they employ over five million

American workers, maintain an annual payroll of over $400 billion, and account for six percent of private sector output – over 40 percent of which is concentrated in manufacturing. While they account for less than one percent of all U.S. businesses, the taxes paid by U.S. affiliates of foreign companies in fact account for 17 percent of corporate taxes collected. On top of tax payments, these companies reinvest billions of earnings back into their U.S. operations every year.

Foreign direct investment tends to disproportionately support a high-quality American workforce. U.S. subsidiaries pay their employees over 30 percent more than the average company, reflecting the high-skill nature of the scientific, engineering, and manufacturing jobs they create and sustain. In the hard-hit manufacturing sector alone, U.S. subsidiaries account for 13 percent of the labor force – over two million jobs.

Annually, foreign direct investment leads to over $40 billion in domestic research and development (R&D), accounting for more than 14 percent of America's private R&D investment. Many global companies choose to locate their global R&D headquarters in the United States in order to access a skilled workforce and favorable environment for innovation. This has tremendous benefits for the United States and is a factor that deserves careful consideration as part of tax reform.

Although counterintuitive to some, many globally based companies have established their American operations as a platform from which to manufacture goods to sell to the world. Their U.S. affiliates produce more than 18 percent of total U.S. exports – work that is helping our country reach the National Export Initiative goal of doubling exports by the year 2015.

As noted in a recent report by the President's Council of Economic Advisors, the vast majority of inbound investment originates from firms domiciled in other advanced economies. In 2010, almost 90 percent of inbound investment in this country came from Canada, Europe and Japan. In comparison, the report notes that only 2.1 percent of total inbound FDI originated from the rapidly growing economies of Brazil, China, and India combined.

It is also worth noting that, for all the headlines it generates, Chinese investment accounts for a miniscule portion – less than one percent – of foreign investment in the United States. And, according to the latest Department of Commerce statistics, the vast majority – 98 percent – of all foreign investment comes from the private sector.

The extensive benefits of inbound investment present a compelling case for open economic policies that encourage global companies to establish business here and boost America's economic growth.

Dynamic Competitive Landscape

In the midst of recent economic challenges, foreign investment continues to be an engine for job creation and a catalyst for growth and prosperity throughout the country.

As one example, at a time when the unemployment rate is a focus of national attention, Netherlands-based Philips Electronics is working to add 1,500 new jobs across the country. The company already employs over 25,000 people in United States, including over 1,000 at its manufacturing facility in Highland Heights, Ohio, where they develop, produce, and export high end medical-imaging technologies, such as MRI and CT scanners for customers around the world. Philips also chose to place the global headquarters of its healthcare division in Massachusetts and does the vast majority of its worldwide healthcare manufacturing work in the United States.

The competition to attract and retain companies like Philips has never been stronger. Companies today have an unprecedented array of options when looking to expand their business around the world. As a result, while America remains the largest recipient of the world's investment, its share is shrinking. A decade ago, the United States claimed more than 40 percent of cross-border capital but has seen its share shrink to less than half that amount today. In 2010, the United Nations Conference on Trade and Development (UNCTAD) found that, for the first time ever, developing economies claimed the majority of global FDI inflows – something that policymakers in the developed world would do well to keep in mind as they weigh the benefits of various economic and tax proposals. These changes are the result of a number of factors, but can in part be attributed to the aggressive efforts of other countries to attract and retain high-quality, job-creating investment from abroad.

Recent Attention to FDI

The Administration has taken steps in the last two weeks that suggest a growing understanding of the need to enhance American competitiveness to attract foreign investment.

Earlier this week, the President issued an investment policy statement that reaffirms our nation's long-standing commitment to open investment policies and recognizes the benefits of foreign direct investment in America's economy. This is the first such statement from a Democratic President in more than 30 years, and sends an important message to the international business community that America is committed to maintaining its leadership in promoting free and open markets at home and abroad. This action follows closely on the heels of an Executive Order signed last week to create a government-wide initiative entitled ***SelectUSA*** that will actively market the United States as a destination for foreign investment.

These developments help set the tone for a more favorable business environment for inbound investment, but must be followed by meaningful steps on core issues like tax reform, regulatory reform, and infrastructure investment if the United States is to remain competitive with the rest of the world for investment.

Tax Considerations

As American businesses, OFII's members share many of the same concerns regarding tax policy as other U.S. companies. OFII sees tax reform is an important opportunity to encourage greater foreign direct investment in the United States. In this regard, we believe Congress should give due consideration to two overriding factors in considering U.S. tax reform.

First, OFII is united with the broader American business community in its support for reducing the U.S. federal corporate income tax rate. Last year, OFII conducted a CFO survey on the investment decisions of global companies. Based on the results of the survey, we strongly believe that reducing the U.S. federal corporate income tax rate will significantly increase investment in the United States, which will lead to further job growth.

Second, in pursuing tax reform, OFII encourages increasing the certainty, transparency, and reliability of the U.S. tax system in a manner that is not discriminatory against the U.S. subsidiaries of foreign business enterprises that invest in America. Such an approach will similarly lead to increased U.S. investment and job creation. I would like to take this opportunity to discuss a few areas in the tax law that provide opportunities for improving the attractiveness of the United States as a location for investment by removing impediments to foreign investment in the United States.

Section 163(j)

One of the most burdensome U.S. tax limitations imposed on U.S. subsidiaries is section 163(j). These rules, originally enacted in 1989, disallow current deductions for certain interest paid by domestic corporations to foreign related parties and tax-exempt entities. This limitation is imposed to the extent the debt-to-equity ratio of the corporation exceeds 1.5 to 1, and the corporation's net interest expense exceeds 50 percent of the domestic corporation's adjusted taxable income. These rules were expanded in 1993 to apply to interest paid by domestic corporations to unrelated parties and guaranteed by a foreign related party.

The current section 163(j) rules are overly broad, have a discriminatory impact on U.S. subsidiaries, and serve to reduce investment in the United States. Section 163(j) principally impacts U.S. subsidiaries of foreign-owned corporations. OFII has had longstanding objections to these rules because they discriminate against foreign-owned U.S. companies. In addition, they violate the U.S. commitment in our tax treaties to not impose discriminatory taxation. The nondiscrimination article of virtually all U.S. income tax treaties commits the United States to permit U.S. companies a deduction for interest paid to a treaty-partner resident to the same extent that it would be allowed for interest paid to a U.S. resident. This is a mutual commitment, meaning that the treaty partner commits to the same obligation to avoid discriminatory tax treatment of U.S. residents investing in the treaty partner's jurisdiction.

There are valid business reasons for funding a U.S. subsidiary with debt. In many cases, the ability of a foreign multinational to finance its U.S. subsidiaries' operations in an economically viable manner requires using a degree of debt financing. However, because the U.S. subsidiary on a stand-alone basis often lacks the high credit rating that would allow the U.S. subsidiary to borrow from unrelated parties at competitive interest rates, the only way the U.S. subsidiary can obtain low-cost debt capital is by borrowing from its foreign parent company (or another affiliate that acts as the financing arm of the corporate group), which in turn can more efficiently borrow from the worldwide credit markets. Alternatively, the U.S. subsidiary can borrow from unrelated parties with a foreign parent guarantee in order to reduce the amount of interest otherwise payable on the debt.

Tightening section 163(j) would increase the cost of capital for U.S. subsidiaries, thereby reducing the after-tax return on investment that they earn from their U.S. operations. This would likely result in lower levels of investment in the United States. As the Joint Committee on Taxation has recently stated, "the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as [proposals to tighten section 163(j)]."

There have been proposals in recent years to further restrict current law interest deductions under 163(j), primarily for related party debt, but none of those proposals were based on economic data or statistics demonstrating that further restrictions were justified. OFII believes that any further changes to section 163(j) should not be adverse. In fact, similar to legislation passed in the Senate in 2004, consideration should be given to eliminating the application of section 163(j) to guaranteed debt, particularly where the interest is subject to U.S. net income tax by the unrelated U.S. third party.

In its 2007 report on earnings stripping, the Treasury Department found no conclusive evidence of earnings stripping by U.S. subsidiaries. The U.S. tax law has robust statutory and common law tools that require taxpayers to employ only an appropriate amount of related party debt financing and on terms that are comparable to what would be agreed on an arm's length basis with unrelated parties. In order for interest to be deductible, the taxpayer must establish that it was paid in respect of a bona fide debt, which is determined under a broad set of common law standards. These standards are vigorously enforced by the IRS and are applied as a threshold matter before the mechanical and arbitrary limitation rules under current law section 163(j). Any further adverse extension of these discriminatory and arbitrary rules of section 163(j) would further amplify the discriminatory impact on U.S. subsidiaries, and further reduce the levels of investment in the United States that might otherwise be available to enhance job creation.

Tax Treaties

In pursuing tax reform, respect for our obligations under U.S. income tax treaties should be of paramount importance. Income tax treaties play a fundamental role in U.S. international tax policy. A basic purpose of tax treaties is the promotion of bilateral trade and investment, to the benefit of both U.S. and foreign multinational corporations and the

global economy. Treaties reconcile the independently developed tax laws of treaty partners in order to avoid double taxation and excessive taxation of cross-border income. In that way, tax treaties remove artificial barriers to bilateral trade and investment. Treaties also include a commitment made by both countries to avoid discriminatory tax treatment of residents of the other country, a commitment that has been a bedrock treaty policy of the United States almost from the beginning of the U.S. tax treaty program.

Virtually all multinational enterprises with operations in countries with which the United States has a treaty rely on our tax treaties to provide greater objectivity, clarity, and certainty in how cross-border transactions will be taxed by the treaty partners and also rely on treaties for the ability to avoid potential double taxation where there are disputes. In addition, treaties provide important tools to the tax administrations of the treaty partners for policing cross-border activities through the exchange of information and cooperation in enforcement of the tax laws.

Tax treaties provide greater certainty and clarity to foreign taxpayers investing in the United States regarding their potential U.S. tax liability but only if the treaties' provisions are respected. Our treaties reflect the results of good faith bargaining whereby each country agrees to concessions in exchange for the greater benefits that result from the treaty relationship. Changes in the U.S. tax laws should not override, or conflict with, our existing U.S. tax treaty obligations. Such actions result in less certainty and confidence in our tax rules and, thus, can lead to reduced investment in the United States. Such adverse changes in law also send a message to our treaty partners that they cannot rely on the mutual concessions made in the treaty.

In addition, as the 2007 Treasury Department report on treaties indicates, the Treasury Department has effectively policed perceived tax abuses by insisting that new treaties contain robust anti-treaty shopping rules, reflected in the Limitation on Benefits article of treaties, and by renegotiating our existing income tax treaties to include LOB provisions in line with current U.S. anti-treaty shopping standards. These provisions ensure that the treaties are used by appropriate parties. Most U.S. income tax treaties contain an LOB provision, and the Treasury Department has diligently worked to renegotiate existing treaties that lack a robust LOB article to include such an article where those treaties may be susceptible to inappropriate use by residents of third countries. Recent examples include the income tax treaties with Iceland (in force), Hungary (near ratification), and Poland (near completion).

Consistent with the Administration's efforts, the strengthening of the U.S. tax treaty network in this manner is the appropriate path to address perceived abuses, rather than through domestic tax law changes that can override, or conflict with, the treaty's provisions, including possible violation of the non-discrimination rules that the U.S. insists be a part of every treaty. Recent examples of some of these concerns include proposals to override tax treaties with respect to deductible payments to affiliated entities that qualify for treaty rates, and proposals to tax foreign corporations as U.S. corporations if they are primarily managed in the United States.

Importantly, treaty overrides are not limited to federal legislation. In certain cases, individual States have effectively overridden the provisions of U.S. tax treaties (*e.g.*,

State rules that "add back" certain income for State tax purposes or mandate the inclusion of certain foreign entities in a state tax filing, where such income or entity is otherwise entitled to benefits under U.S. federal income tax treaties). This increasing trend by States is of great concern to OFII members and to the governments of their respective home countries and is an impediment to investment in the U.S. OFII would be happy to discuss further ways to enhance the certainty of the U.S. tax treaty network in order to increase U.S. investment in a manner consistent with the important tax treaty principles discussed above, including non-discrimination provisions that the United States has consistently advocated throughout the life of our tax treaty program.

Transfer Pricing

The U.S. transfer pricing rules, which are contained in section 482 of the tax code and the regulations thereunder, apply for purposes of determining the appropriate prices of goods, services, and intangible property transferred between related companies. These rules are intended to achieve the internationally accepted arm's length standard. These principles are also reflected in our U.S. income tax treaties, which seek to resolve cases of double taxation involving more than one taxing jurisdiction. Current transfer pricing rules have resulted in substantial complexity and uncertainty in their application to our members.

OFII commends the efforts that have been made to date to reduce uncertainty in this area, including reducing administrative burdens in certain cases associated with complying with the transfer pricing rules, as well as increasing the ability to determine in advance appropriate transfer pricing methodologies under the IRS' Advanced Pricing Agreement program (both unilaterally and bilaterally with our treaty partners) and fully supports adding additional resources to these programs. OFII also commends the efforts to include in more U.S. income tax treaties binding arbitration provisions that seek to resolve in a timelier manner transfer pricing disputes between treaty countries' taxing authorities. OFII looks forward to working with the Congress and the Administration on additional ways to increase certainty in this area.

I am pleased to answer any questions you may have, and look forward to working with this Committee and the Congress in considering tax reform that will increase investment in the United States.

Chairman TIBERI. Thank you, Ms. McLernon.

Mr. Spitzer, you are recognized for 5 minutes.

STATEMENT OF ALEXANDER SPITZER, SENIOR VICE PRESIDENT, TAXES, NESTLE HOLDINGS, INC., NORWALK, CONNECTICUT

Mr. SPITZER. Yes, thank you. Good morning. My name is Alex Spitzer. Mr. Chairman, Ranking Member, Members of the Committee, I am grateful for the opportunity to share my personal views on international tax policy, as it relates to U.S. operations of multinational firms and, in particular, any impediments that

may serve as a barrier to attracting international investment into the U.S. manufacturing base.

I am senior vice president of taxes for Nestle in the U.S., and have held the top job in the company for the last 26 years. Nestle, a Swiss public company, is the world's largest food company, with sales over 100 billion, and was established in 1866, 50 years-plus before the enactment of the U.S. federal income tax.

For more than 110 years, Nestle has been insourcing into the U.S. and investing in American factories, jobs, and businesses. Our first factory in the U.S. was built around 1900 in Upstate New York to produce chocolate products. Nestle manufactures, in the U.S., a large range of products, including Stouffers, Lean Cuisine, Gerber, Jenny Craig, PowerBar, Hot Pockets, Poland Spring, Deer Park, Edy's, Haagen-Dazs ice cream, Nescafe Coffee, CoffeeMate, DiGiorno Pizza, and also in the pet food area, Friskies, Alpo, Purina, and Beneful.

We have a total of 51,000 employees in the U.S., and 85 manufacturing facilities and 7 R&D centers. Nestle's U.S.-manufactured product sales approximate 28 billion annually, including 600 million in exports out of the U.S.

Nestle in the U.S. has been consistently ranked by Fortune magazine as the number one consumer food products company in the industry. Excluding acquisitions, we have invested approximately 5.5 billion over the last 6 years in M&A and factories in our U.S. businesses. And since I have been at the company, we have reinvested just about all of our U.S. profits back into our operations here to grow our U.S. businesses.

When Nestle acquires a business, we usually maintain current management and increase investment and expansion, rather than cut costs or dismantle the business. For example, after we completed our Dreyer's acquisition, we invested over 100 million in expanding our Bakersfield, California plant, making it the largest ice cream factory in the world.

Turning to tax policy, there has been much discussion of the U.S. corporate tax rate and its impact on the country's ability to compete for global investment. There is no doubt that a lower tax rate and a more transparent Tax Code would make the U.S. more competitive for investment from abroad. The rest of the world is moving towards lower tax rates. Simply put, the U.S. must do the same.

However, I also want to highlight a number of other areas of particular interest to my business. The ability of the inbound business community and Nestle itself to deduct ordinary and necessary business expenses related to investments, such as interest and royalty for both federal and state tax purposes is of great concern, and weighs heavily on our investment decisions.

Not only are inbound companies singled out with regard to restrictions on the deductibility of debt service via section 163(j), recently there seems to be a coordinated IRS effort to audit inbound companies with regard to debt equity type issues, although there is no indication of any abuse. Despite the fact that a 2007 treasury report found no evidence of widespread abuse with regard to section 163(j), there is still much uncertainty regarding further re-

strictive legislation in this area. This uncertainty weighs heavily on investment decisions.

In addition, various legislative proposals concerning corporate residency rules, treaty overrides, also contribute to the climate of uncertainty. There is now growing uncertainty at the state level. In many cases, states seem to be bent on conducting their own individual foreign fiscal policy. Many states have enacted legislation to deny deduction of interest and royalties paid to foreign parent companies, even those headquartered in treaty countries. These initiatives would violate the federal and treaty rules concerning permanent establishments. And, unlike most sub-national governments, the states are not bound by the U.S. tax treaties.

While I understand this is not within the committee's jurisdiction, it would be helpful if members would promote the inclusion of the states in upcoming treaties. If this trend of taxation continues, I am afraid not only will it discourage investment into the U.S., but it will jeopardize our tax treaty network and/or encourage reciprocal treatment by our treaty and trading partners.

In this regard, a proposal to deal with the growing problem has already been introduced. I ask that you review and support the Business Activity Tax Simplification Act of 2011, which is currently before the House Subcommittee on Courts, Commercial, Administrative Law of the House Committee on the Judiciary.

As a U.S. citizen, I think it important for the United States to create a competitive environment to attract and maintain investment by a competitive tax regime, as well as ensure fairness and certainty in our tax rules and administration. We should put the welcome mat out for investment in an affirmative, proactive manner.

As the committee moves forward in considering reforms to the tax system, I urge that you do so in a non-discriminatory way that maximizes job-creating investment in the United States.

Thank you for thoughtfully framing this discussion. I am happy to respond to any questions.

[The prepared statement of Mr. Spitzer follows:]

Written Testimony of

Alexander Spitzer

Senior Vice President - Taxes, Nestlé

Before the

Subcommittee on Select Revenue Measures

Committee on Ways and Means

United States House of Representatives

June 23, 2011

Good morning. My name is Alexander Spitzer. Mr. Chairman, I am grateful for this opportunity to share with the Committee my personal views on international tax policy as it relates to U.S. operations of multinational firms and, in particular, any impediments that may serve as a barrier to attracting international investment into the U.S. manufacturing base.

I am Senior Vice President - Taxes for Nestlé in the U.S. and have held the top tax job in the company for the last 26 years. Also, from 1996-2002, I served as President of the Organization for International Investment (OFII) and I continue to serve on OFII's Executive Committee.

As the top tax executive for a major U.S. subsidiary of a Swiss-based multinational and as long-time President of the inbound investment community's leading association, I

believe that I have a unique perspective to offer the Committee today. Thank you for inviting me.

Nestlé in the United States

Nestlé, a Swiss public company, is the world's largest food company with sales over $100 billion and was established in 1866 (50 years before the enactment of the U.S. federal income tax). For more than 110 years, Nestlé has been insourcing into the U.S. and investing in American factories, jobs and businesses. Our first factory in the U.S. was built around 1900 in upstate New York to produce chocolate products. Nestlé manufactures in the U.S. a large range of products including Stouffer's & Lean Cuisine, Gerber, Jenny Craig, PowerBar, Hot Pockets, Poland Spring, Deer Park, Edy's & Häägen-Dazs Ice Cream, Butterfinger, Crunch, Libby's Juicy Juice, Nescafé Coffee, Coffee-Mate, DIGIORNO Pizza, also Pet Food's Friskies, Alpo, Purina, and Beneful. We have a total of 51,000 employees at 85 manufacturing facilities, and 7 U.S. R&D centers. Nestlé's U.S. manufactured product sales approximate $28.0 billion annually, including $600 million in exports.

Nestlé in the U.S. has been consistently ranked by *Fortune* magazine as the **# 1** consumer foods products company in the industry. Our Pet Food Company, Purina, is one of 7 companies in 2010 winning the Malcolm Baldrige Quality Award.

Excluding acquisitions, we have invested approximately $5.5 billion over the last 6 years in M&E and factories in our U.S. businesses. For example, we have recently completed

a $650 million factory investment in Anderson, Indiana making aseptic packaged beverages like NesQuik and Coffee-Mate. Gerber has recently opened a call center in Muskegon, Michigan (not India) and also invested in a $90 million expansion in its Fort Smith, Arkansas factory. And, Nestlé Purina has recently installed the largest solar renewable power system in Colorado at its Denver PetCare plant … if it works well … we will continue to make such investments at other plants.

Some of our other U.S. facilities include our Dublin, Ohio Quality Assurance Center employing approximately 115 people; our Franklin Park, Illinois chocolate factory employing approximately 750 people; our Itasca, Illinois Willy Wonka candy factory employing 300 people and our Dallas, Texas Water Production company which employs approximately 250 people.

When Nestlé acquires a business, we usually maintain current management and **increase** investment and **expansion** rather than cut costs or dismantle the business. This approach is more common with cross border acquisitions than domestic-to-domestic acquisitions, in which there is more often redundancy and, therefore, a higher likelihood of layoffs. For example, after we completed our Dreyer's acquisition, we invested over $100 million in expanding our Bakersfield, California plant making it the largest ice cream factory in the world.

Disincentives and Impediments to Investing in the United States

There has been much discussion of the U.S. corporate tax rate and its impact on the country's ability to compete for global investment. There is no doubt that a lower rate and a more transparent tax code would make the U.S. more competitive for investment from abroad. The rest of the world is moving towards lower rates; simply put, the U.S. must do the same. However, I also want to highlight a number of other areas of particular interest to my business community.

The ability of the inbound business community and Nestlé itself to deduct ordinary and necessary business expenses related to investment such as interest and royalties for both federal and state purposes is of great concern and weighs heavily on our investment decisions. Not only are inbound companies singled out (as opposed to U.S.-headquartered companies) with regard to restrictions on the deductibility of debt service via Section 163(j), recently there seems to be a coordinated IRS effort to audit dozens of inbound companies with regard to debt/equity type issues although there is no indication of any abuse.

Despite the fact that a 2007 Treasury report found no evidence of wide-spread abuse with regard to Section 163(j), there is still much uncertainty regarding further restrictive legislation in this area. This uncertainty weighs heavily on investment decisions. Various legislative proposals concerning corporate residency rules, treaty overrides, as well as IRS administrative practices also contribute to the climate of uncertainty.

With regard to the states, in many cases they seem to be bent on conducting their own individual foreign fiscal policy. Many states have enacted legislation to deny the deduction of interest and royalties paid to foreign parent companies, even those headquartered in treaty countries. At great effort, OFII has educated many such states on the importance of including treaty exceptions that ensure the state is aligned with U.S. tax treaty obligations.

However, many states are now attempting to bring foreign parent companies and affiliates, who have no physical presence in the U.S., into their states for tax purposes. This would violate the federal and treaty rules concerning permanent establishments, but unlike most foreign sub-national governments, the states are not bound by U.S. tax treaties.

It would be helpful if the Committee would use its best efforts to promote the inclusion of the states in upcoming treaties. If this trend of state taxation continues, I'm afraid not only will it discourage investment into the U.S., but it could jeopardize our tax treaty network and/or encourage reciprocal treatment by our treaty and trading partners.

In this regard, the enactment of the BATSA bill (The Business Activity Tax Simplification Act of 2011 – H.R. 1439) before the House Subcommittee on Courts, Commercial and Administrative Law of the House Committee on the Judiciary would be important so as to limit the states' application of "economic nexus" theories to foreign companies which

have no physical presence in the U.S. (link to bill text:

http://www.gpo.gov/fdsys/pkg/BILLS-112hr1439ih/pdf/BILLS-112hr1439ih.pdf).

As a U.S. citizen, I think it important for the United States to create a competitive environment to attract and maintain investment via a competitive tax regime as well as ensure fairness and certainty in our tax rules and administration. We should put the welcome mat out for investment in an affirmative, proactive manner.

As the Committee moves forward in considering reforms to the tax system, I urge you to do so in a non-discriminatory way that maximizes job-creating investment in the United States. Thank you for thoughtfully framing this discussion. I am happy to answer any questions.

Chairman TIBERI. Thank you, Mr. Spitzer.
Mr. DRAILLARD.

STATEMENT OF CLAUDE DRAILLARD, CHIEF FINANCIAL OFFICER, DASSAULT FALCON JET CORPORATION, LITTLE FERRY, NEW JERSEY

Mr. DRAILLARD. Good morning. My name is Claude Draillard, and I am the chief financial officer of Dassault Falcon Jet Corporation. Thank you for inviting me to testify this morning.

Dassault Falcon Jet Corporation—DFJ, in short—is a fully-owned U.S. subsidiary of Dassault Aviation, a French business air-

craft manufacturer which is a major player in the global aviation industry.

Since 1972, DFJ's operations have grown from a small sales office in New York City to a company with 7 locations throughout the United States. DFJ and its subsidiaries currently employ a staff of over 2,500 workers in the U.S., and is a major provider of jobs, mostly in Arkansas, New Jersey, and other states. DFJ also has offices in nine other states. And as the business aircraft market is a global market, we also operate a number of sales offices internationally.

DFJ and its subsidiaries in the United States are operating in the following lines of business for Falcon aircraft: sale of new and pre-owned for the United States, Canada, Mexico, South America, Pacific Rim, and Asia; outfitting and customization of the vast majority of Falcon aircraft, including engineering, and this includes Falcon aircraft sold outside of DFJ's territory; some research and development work for cabin and cockpit options, either as in-production installation or as after-market installation; and all after-market services, such as sales and repair of spare parts.

DFJ provides quality, high-salaried jobs throughout the United States. The nature of DFJ's business requires the employment and training of highly-skilled professionals in all locations: engineers, pilots, support engineers and technicians, aviation mechanics, but also CPAs and other types of professionals.

DFJ also provides indirect employment all across the United States through a network of suppliers of all sizes, including divisions of major equipment manufacturers, such as United Technologies, as well as local vendors that help provide flexibility to our production operations.

Because business aviation is a high-tech, highly regulated industry with very demanding customers, continued investment in technology and facilities is necessary to operate a long-standing profitable company. DFJ has a history of reinvesting the cash generated by its American operations back into the United States in the form of new technologies and production upgrades, rather than distributing dividends to its foreign parent.

This trend has allowed DFJ to make additional investments in the U.S. DFJ's average capital expenditure, excluding R&D, in the last 10 years has been in the vicinity of 15 million per year, enabling the company to expand its Little Rock, Arkansas, operations, enhance its maintenance operations, and invest in new IT tools and other product life cycle management tools.

With the globalization of the economy, the relative weight of the United States market in new orders for new and pre-owned aircraft has decreased. Even though it remains a significant market in number of units, the U.S. is no longer a growing market, but mostly a mature renewal market.

Like everyone else, DFJ is navigating the current economic uncertainties and the dramatic changes in world economic powers. In this fragile time of recovery and economic change, an array of uncertainties in U.S. tax policies and regulations add obstacles to growth and new investment. In addition to the U.S. corporate rate already being the second highest in the world, there is concern of a rising direct and indirect tax burden for U.S. businesses.

At the same time, some emerging countries are experiencing budget surpluses that increase their ability to provide ever bigger tax incentives. In anticipation of this, businesses are asking themselves, "Should we keep investing in the U.S. when the country's economy does not seem to be recovering quickly? Should we look to move where countries are providing tax incentives for investment?"

Will current provisions to encourage investment and job creation be able to survive, such as R&D credit and domestic manufacturer's deduction, to provide some measure of relief?

At the same time, U.S. tax regulations, along with IRS announcements and private letter rulings, have reached a new level of complexity. Interpretations are becoming ever more difficult to understand and reconcile. Disagreement in the reading of tax regulations and provisions has significantly lowered the pace of transaction between parties.

Another layer of complexity is added when state tax legislation comes into play. For structured transactions such as international leases of business aircraft, a number of elements need to be analyzed on top of federal tax issues, states question the validity for them of tax treaties. State sales tax, use tax, and income tax provisions make certain types of transactions extremely costly.

The business aviation industry is geographically shifting. While DFJ is committed to its United States investments, there is increasing incentive to look elsewhere to deploy our resources. Needless to say, predictable, pro-growth tax policy and simplification of federal regulations would make it more attractive to maintain our investment in the United States.

I will be happy to answer any of your questions.

[The prepared statement of Mr. Draillard follows:]

Written Testimony of Claude Draillard
Chief Financial Officer
Dassault Falcon Jet Corp.

Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

June 23, 2011

Good Morning. My name is Claude Draillard and I am the Chief Financial Officer of Dassault Falcon Jet Corporation. Thank you for inviting me to testify this morning.

Dassault Falcon Jet Corp. (DFJ) is a fully owned U.S. subsidiary of Dassault Aviation S.A., a French business and military aircraft manufacturer, which is a major player in the global aviation industry.

Since 1972, DFJ's operations have grown from a small sales office in New York City to a company with seven locations throughout the U.S. DFJ and its subsidiaries currently employ a staff of over 2,500 workers in the U.S. and is a major provider of jobs in Arkansas, New Jersey, Delaware, Florida, Nevada, and Idaho.

DFJ also has offices in nine other States in order to service all customers and prospects in the U.S. In addition, as the business aircraft market is a global market, DFJ operates a number of sales offices internationally.

DFJ and its subsidiaries in the United States are operating in the following lines of business for Falcon aircraft:

- The sale of new and pre-owned aircraft for the United States, Canada, Mexico, South America, the Pacific rim and Asia;
- The outfitting and customization of the vast majority of Falcon aircraft, including the related engineering. This includes Falcon aircraft sold outside of DFJ's territory;
- Some R&D for cabin and cockpit options either as in-production installation or as aftermarket installation;
- The sale, exchange and repair of spare parts;
- The technical support of the in-service fleet; and,
- The maintenance of in-service aircraft.

DFJ provides quality, high-salaried jobs throughout the U.S. The nature of DFJ's business requires the employment and training of highly-skilled professionals in all locations: engineers, pilots, support engineers and technicians, aviation mechanics but also CPAs and other types of specialized professionals.

DFJ also provides indirect employment all across the United States through a network of suppliers of all sizes, including divisions of major equipment manufacturers like United Technologies as well as local vendors that help providing flexibility to production operations.

Committed to Reinvesting in the U.S.

Because business aviation is a high-tech, highly regulated industry with very demanding customers, continued investment in technology and facilities is necessary to operate a long-standing, profitable company.

DFJ has a history of reinvesting the cash generated by its American operations back into the U.S. in the form of new technologies and production upgrades, rather than distributing dividends to its foreign parent company. This strategy has allowed DFJ to make additional investments in the U.S. DFJ's average capital expenditure in the last 10 years has been in the vicinity of $15 million per year, enabling the company to:

- Expand its Little Rock, AR production and engineering site (new Engineering wing of 12,000sqft built in 2007 after rebuilding a 15,600sqft Engineering area);
- Enhance its maintenance operations (acquisition of Atlantic Aviation in Wilmington, DE in 2001 ; new service center opened in Reno, NV in 2009); and,
- Invest in new IT tools and other Product Lifecycle Management (PLM) software.

DFJ and the Global Economy

With the globalization of the economy, the relative weight of the U.S. market in new orders for new and pre-owned aircraft has decreased. Even though it remains a significant market in numbers of units, the U.S. is no longer a growing market but mostly a mature renewal market. The recent economic downturn has amplified this trend, which began as early as the second half of 2004 for our company.

This dramatic globalization of our business has changed DFJ's existing customers' behavior and has also opened the door to new customers, mostly outside of the U.S.

Customers that are either new to business aviation or to the high-end part of the market present new challenges for our company. Most of these new customers are located in areas where infrastructure is scarce and technical knowledge and skills are either rare or non-existent.

This scarcity of operational resources has created an incentive for all business aircraft manufacturers to seek local organizations capable of providing these services. However, as fleets are still relatively small, it is almost impossible for new service providers to be profitable in those locations. Therefore, manufacturers have been tempted to re-allocate their resources (human, technical and financial) to those areas outside of the United States.

DFJ has chosen to keep the United States as the main center of its operations for those secluded or little equipped areas, even though our customer base is moving overseas. This market pressure has been enhanced by the economic downturn: shareholders have questioned why DFJ

is still investing in its U.S. operations when the market for new aircraft has shifted to countries like Brazil, Russia, India and China.

Challenges for DFJ's Growth and Additional U.S. Investment

Like everyone else, DFJ is navigating the current economic uncertainties and the dramatic changes in world economic powers.

In this fragile time of recovery and economic change, an array of uncertainties in U.S. tax policies and regulations add obstacles to growth and new investment. In addition to the U.S. corporate rate already being the second highest in the world, there is concern over rising direct and indirect tax burden for U.S. businesses. At the same time, some emerging countries are experiencing budget surpluses that increase their ability to provide ever bigger tax incentives.

In anticipation of this, businesses are asking themselves:

- Should we keep investing in the U.S. when the country's economy does not seem to be recovering quickly?
- Should we look to move where countries are providing tax incentives for investment?
- Will current provisions to encourage investment and job creation be able to survive (i.e. R&D credit, Domestic Manufacturers Deduction, etc…) to provide some measure of relief?

At the same time, U.S. tax regulations, along with IRS pronouncements and private letter rulings, have reached a new level of complexity. Interpretations are becoming ever more difficult to understand and reconcile. Disagreement in the reading of tax regulations and provisions has significantly lowered the pace of transactions between parties.

For instance, the current accelerated depreciation mechanism (also known as "bonus depreciation") has a number of criteria to qualify for the said accelerated depreciation. Structuring the financing of new aircraft transactions so that both the financing institution and the end user benefit from the bonus depreciation requires an unprecedented effort and number of people involved. This has increased the cost of the transaction to a point where discussions on the price appear to be relatively simple and straightforward.

Another layer of complexity is added when State tax legislation comes into play. For structured transactions such as international leases of business aircraft, a number of elements need to be analyzed on top of Federal tax issues:

- Some States question the validity for them of tax treaties that bind the Federal government and foreign governments
- States sales tax, use tax or income tax provisions make certain type of transactions extremely costly and/or cumbersome. Therefore, business aircraft transactions tend to be concluded and closings take place in other States that provide, from a tax legislation standpoint, either clearer rules and/or more stability in their rules or better tax conditions.

Conclusion

The business aviation industry is geographically shifting. While DFJ is committed to its U.S. investment, there is increasing incentive to look elsewhere to deploy our resources. Needless to say, predictable, pro-growth tax policy and simplification of federal regulations would make it more attractive to maintain our investment in the United States.

Chairman TIBERI. Thank you, sir.

Mr. DeBoer, you are recognized for 5 minutes.

STATEMENT OF JEFFREY DEBOER, PRESIDENT & CHIEF EXECUTIVE OFFICER, THE REAL ESTATE ROUNDTABLE, ALEXANDRIA, VIRGINIA

Mr. DEBOER. Thank you, and good morning. My name is Jeff DeBoer, I am president and CEO of the Real Estate Roundtable.

President Obama had it correct earlier this week when he said investments by foreign-domiciled companies and investors create well-paid jobs, contribute to economic growth, productivity, and

support American communities. Unfortunately, the reality is, in the case of foreign capital investment and U.S. commercial real estate, our current laws significantly discourage the type of job-creating economic growth that the President was touting.

America needs to be able to compete globally for investment capital for all types of positive economic activities. And today that simply isn't the case when we compete globally for capital for our real estate markets.

Our commercial real estate markets historically have been very positive contributors to economic growth. Healthy commercial real estate markets provide jobs in construction, design, management, architecture, and many other areas. Strong real estate values provide the resources through property tax payments and transfer fees to fund local budgets and pay for roads, police, and education needs that we all think are essential to healthy communities.

But today, while some commercial real estate markets have started to come back, most markets nationwide remain deeply troubled. They are marked by very weak property values caused by excessively high unemployment, the lack of business expansion, and extremely low consumer confidence.

In addition, large amounts of commercial real estate debt are maturing. But because of steep property declines and restrictive credit availability, trillions of dollars of commercial real estate debt nationwide will not be able to be refinanced without large infusions of equity capital. The resulting burden on our nation's banking system, particularly community banks, is inhibiting small business lending and holding back job creation.

Everyone in my industry asks, "Where will the capital come from that is needed to rebalance our loans?" One source that is ready and willing is foreign-based capital. However, while ready and willing to invest, this capital is essentially not able to invest, because the Foreign Investment in Real Property Tax Act, FIRPTA, make it highly undesirable, economically and administratively.

FIRPTA is a discriminatory tax. It only applies to foreign investors in U.S. real property. The 35 percent FIRPTA tax, combined with state and local taxes, and frequently with the branch profits tax, results in a foreign investor paying a tax as high as 54 percent on capital gain.

In addition, the administrative burdens and cost associated with structuring investments in U.S. real estate is significant. No other asset class faces this tax.

A report by University of California professor Ken Rosen found that reforming FIRPTA would unlock billions of dollars in investments into U.S. commercial real estate. This is capital that is currently sitting on the sidelines or, more likely, going to other countries that have more favorable tax rules.

The time has come and gone for FIRPTA. Frankly, it should be repealed, and perhaps you can do that in tax reform. There are meaningful, cost-efficient reforms that can and should be made now, however. We are pleased that Congressman Brady and Congressman Crowley and other Members of the Committee are working on legislation to make two simple meaningful changes.

First, the existing small shareholder exemption for foreign investments in publicly-traded REITs should be doubled from 5 to 10 percent.

Second, an IRS notice called 2007–55 should be withdrawn. Action in this area would significantly help smaller markets, where capital is most needed. This latter point on the IRS notice does not require legislation; Treasury could do it now with the stroke of a pen. In this regard, we strongly support efforts that Mr. Crowley and Mr. Brady and others on the committee are making to urge the Treasury to review this notice, and hopefully withdraw it.

One other significant issue concerns foreign investment in U.S. debt. There are significant confusions regarding when a foreign source capital can invest in debt in America and restructure that debt. It would be very helpful to have these guidelines straightened out and made more clear.

These simple reforms would spur billions of dollars in foreign investment in U.S. real estate debt and equity. This type of investment would significantly help stabilize troubled lending markets. It would help create jobs. It would help move our economy forward. Importantly, the end result would be to make our nation globally competitive for capital looking to invest in real estate.

Thank you for including our point of view in today's hearing, and I look forward to responding to any questions you have. Thank you.

[The prepared statement of Mr. DeBoer follows:]

The Real Estate Roundtable

STATEMENT OF

JEFFREY D. DEBOER

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS

HEARING
ON
TAX REFORM AND FOREIGN INVESTMENT
IN THE UNITED STATES

LONGWORTH HOUSE OFFICE BUILDING
ROOM 1100
WASHINGTON, DC

THURSDAY, JUNE 23, 2011

Market Square West • 801 Pennsylvania Ave., NW • Suite 720 • Washington, DC 20004 • Phone: 202-639-8400 • Fax: 202-639-8442 • www.rer.org

The Real Estate Roundtable

UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS

ON
TAX REFORM AND FOREIGN INVESTMENT
IN THE UNITED STATES

LONGWORTH HOUSE OFFICE BUILDING
ROOM 1100
WASHINGTON, DC

Thursday, June 23, 2011

STATEMENT OF
JEFFREY D. DEBOER
ON BEHALF OF
THE REAL ESTATE ROUNDTABLE

INTRODUCTION

Chairman Tiberi and Members of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, the Real Estate Roundtable is pleased to submit this statement for the record of the hearing on June 23, 2011 regarding the importance of foreign direct investment to the U.S. economy, and how tax reform might affect foreign-headquartered businesses that invest and create jobs in the United States. The Roundtable represents the leadership of the nation's top privately owned and publicly held real estate ownership, development, lending and management firms, as well as the elected leaders of the 17 major national real estate industry trade associations. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at over $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating Roundtable trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. More information on The Roundtable can be found at www.rer.org.

This statement will address the acute need for increased foreign investment in U.S. real estate, and the critical role that tax reform plays in encouraging this investment. The Roundtable couldn't agree more with President Obama's June 20th statement that, "**[i]nvestments by foreign-domiciled companies and investors create well-paid jobs, contribute to economic growth, boost productivity, and support American communities.**" The U.S. tax system plays a critical role in either encouraging or deterring this investment. The Roundtable applauds the Subcommittee for recognizing this fact, and for considering proposals for simple changes to our tax code that can make investment in the U.S. more attractive to foreign investors, which in turn will create jobs in the U.S.

I. SUMMARY AND ECONOMIC BACKGROUND

A. Summary of Current Conditions

- **The commercial real estate market is in dire need of new equity investment in order to preserve and create jobs.** The commercial real estate market in the U.S. is still reeling from the economic turmoil and precipitous drop in real property values of the past few years. A significant number of jobs in the industry (and associated with the industry) have been lost, and many remain at risk. An infusion of equity capital is sorely needed in order to bridge the financing gap faced by many properties, facilitate redevelopment and new construction, and restore jobs to the industry.

- **FIRPTA acts as a significant deterrent to foreign equity investment in U.S. real property**. The Foreign Investment in Real Property Tax Act ("FIRPTA") presents an onerous tax and administrative burden to foreign investors in U.S. real property companies, a burden not borne by foreign investors in any other U.S. asset class.

- **Uncertainty as to the application of section 864 inhibits foreign investment in U.S. debt.** Current uncertainty as to when an investment in U.S. debt will be treated as a U.S. trade or business of the foreign investor discourages foreign acquisitions of U.S. debt, thereby exacerbating the constrained credit markets faced by U.S. real property owners.

B. Recommendations

- **FIRPTA should be repealed in its entirety**. FIRPTA has succeeded beyond its enactors wildest dreams in discouraging foreign investment in U.S. real property. It is a deterrent to foreign investors, an administrative drain on U.S. corporations and their foreign investors, and without policy justification. If budgetary constraints were not a factor, the Roundtable would recommend that FIRPTA be repealed in its entirety now.

- **Measured, cost-effective FIRPTA reform will encourage increased investment in U.S. real property**. By expanding the FIRPTA exception currently applicable to 5 percent shareholders in publicly-traded real estate investment trusts ("REITs") to 10 percent shareholders, foreign investors will be able to significantly increase investment in U.S. real property. In addition, clarifying that REIT liquidating distributions are treated as sales of stock will

relieve the current uncertainty as to the U.S. tax treatment of these distributions, and encourage greater foreign investment in the U.S. commercial real estate market, particularly in smaller real estate markets.

- **Potential foreign investors in U.S. debt need the U.S. Treasury Department and Internal Revenue Service to issue guidance regarding what constitutes a "U.S. trade or business."** Foreign investors in U.S. debt securities currently face significant uncertainty as to how to structure their debt investments without being treated as engaged in a U.S. trade or business. The Treasury Department and the IRS have been repeatedly petitioned to issue guidance, but have yet to do so. Providing guidelines for foreign investors would attract significant foreign investment into U.S. debt, providing some relief for U.S. borrowers in the current tight credit markets.

- **No position being advocated in this statement will alter the current review process in place for foreign investment in our nation's critical infrastructure.** The tax reform measures we are proposing will in no way affect alter or weaken the laws governing foreign investment in critical infrastructure within the U.S.

- **Now is the time to act.** The commercial real estate market is under stress now. The people dependent on jobs in this market need work now. Now is the time to take affirmative action and induce greater foreign investment into the U.S. commercial real estate market. As summarized in a report by The Rosen Consulting Group, reforming FIRPTA would "unlock billions of dollars in investible capital into the commercial real estate market."[1] This infusion of equity would provide the capital needed to finance maintenance, upgrades and new developments – and employ the thousands of people working in this industry.

C. Economic Background

The U.S. commercial real estate market, plummeted into crisis by the economic upheaval of the past few years, remains vulnerable to further economic stress. While many of the large "gateway" markets are beginning to recover, the remainder of the commercial real estate markets continue to be deeply troubled, contributing to the chronic unemployment in the country, as jobs relating to commercial real estate have been lost and have not returned. Property values have declined over the past three years (approximately 30-50% from 2007 peak to trough), such that some estimate that approximately half of all commercial mortgages are thought to be underwater, while nearly $1.5 trillion in commercial real estate loans will come due in the next four years. As outstanding loans mature, property owners will have difficulty refinancing in the current tight credit markets, particularly in light of decreased property values, forcing many properties into default. The sustained financial pressure on property owners and lack of credit availability has led to deferral of maintenance and upgrades on existing properties, while development of new projects has trickled to a standstill, all resulting in a significant loss of jobs.

---

[1] Rosen, Kenneth T. et al., "*FIRPTA Reform: Key to Reviving Commercial Real Estate*," Rosen Consulting Group, March 2010.

The potential for commercial real estate defaults to derail a fragile economic recovery, particularly in non-gateway markets, and lead to even further job losses, bank closures and business retraction is very real. The need to address the issue is imperative. The real estate community is in agreement that increased equity investment will be a crucial measure in preventing foreclosures, by providing real estate owners with the capital necessary to bridge the gap between financing available and maturing debt. There is consensus that a tremendous amount of potential equity investment capital is in the hands of foreign investors. This significant source of equity capital is needed in the U.S. now.

Preventing a wave of defaults in the commercial real estate market is intrinsically linked to preserving jobs and the general economic health of communities. The Congressional Oversight Panel's February 2010 report "Commercial Real Estate Losses and the Risk to Financial Stability" emphasized the link between the crisis in commercial real estate and the risk to greater job losses, stating:

> Approximately nine million jobs are generated or supported by commercial real estate including jobs in construction, architecture, interior design, engineering, building maintenance and security, landscaping, cleaning services, management, leasing, investment and mortgage lending, and accounting and legal services. Projects that are being stalled or cancelled and properties with vacancy issues are leading to layoffs…The fewer loans that are available for businesses, particularly small businesses, will hamper employment growth…

The report makes clear that commercial property failures lead to a "downward spiral" of economic ramifications, particularly job losses. Measures to bolster the commercial real estate market will have a direct impact on the various employment sectors linked to commercial real estate. Increased equity investment in commercial real estate will provide real property owners with much needed capital to successfully refinance maturing loans and engage in new projects and improvements to existing properties. In sum, providing commercial property owners with this much needed capital would benefit local communities by:

- Preserving jobs tied to commercial real property as property owners are able to refinance loans and maintain ownership of properties
- Bolstering demand for employment in the construction and business maintenance fields as property owners perform delayed upkeep and upgrades
- As concerns regarding possible commercial mortgage defaults are reduced, banks will have greater breathing room to provide small businesses with access to credit, expand their businesses and make new hires

Commercial real estate is intricately connected with the fate of our economic recovery, both locally and nationally. Encouraging greater foreign investment into the real estate market will stimulate job creation and preservation in a critical sector of our economy.

II. CURRENT TAX RULES DISCOURAGE FOREIGN INVESTMENT IN U.S. REAL PROPERTY

A. Taxation under FIRPTA

FIRPTA is a discriminatory tax regime. It is applicable only to investors in U.S. real property. It imposes a higher tax cost on gains from real property, even gains from passive investments, than that imposed on gains from any other type of U.S. asset.

FIRPTA treats any gain or loss realized by a foreign investor in a "U.S. real property interest" as though the gain or loss were effectively connected to a U.S. trade or business, and taxes such gain or loss in the same manner as a U.S. resident would be taxed. The term "U.S. real property interest" includes real property located in the United States as well as interests in any "U.S. real property holding corporation." A "U.S. real property holding corporation" is generally any corporation whose investments in U.S. real property interests equal or exceed 50 percent of the fair market value of the corporation's assets. In summary, under FIRPTA, foreign investors are subject to U.S. tax on the disposition of shares in a U.S. corporation holding U.S. real property, as well as gains realized from direct investments in U.S. real estate.

Foreign investors in no other type of U.S. corporation are subject to U.S. tax on a sale of that corporation's stock. In fact, foreign investors are subject to U.S. tax on capital gains only where those gain relate to real property, effectively punishing foreigners for investing in U.S. real estate, rather than, for example, a U.S. pharmaceutical company. It is unclear what purpose this serves, other than exacerbating the economic distress of a struggling industry.

The taxing regime established by FIRPTA is enforced through complex withholding and reporting obligations. Any transferee of a U.S. real property interest from a foreign transferor is generally required to withhold 10 percent of the transferor's amount realized on the sale. In order to administer this obligation, every U.S. corporation is required to establish whether or not it is a U.S. real property holding corporation. FIRPTA thus presents an administrative burden to U.S. corporations, as well as a financial burden to their foreign investors.

In addition, FIRPTA presents formidable barriers even beyond the FIRPTA taxes themselves. Any investor that is caught in the FIRPTA trap must file a tax return with the IRS, which is not required for any other stock investment and which by itself turns away a substantial number of non-U.S. investors. Compounding these barriers is that FIRPTA also subjects the non-U.S. investor to state and local tax return and tax obligations (again, unique for investors in equity stocks) and in many situations activates the "branch profits" tax, thus triggering an effective federal tax rate as high as 54 percent on these equity investments.

B. The application of FIRPTA to interests in corporations discourages investment in U.S. real property

Foreign investors in U.S. real property typically invest in such property through a U.S. corporation. By taxing gain realized on *stock* in U.S. corporations holding U.S. real property, FIRPTA creates a false dichotomy between investments in U.S. corporations holding U.S. real property and corporations engaged in any other type of activity. As noted above, foreign investors in U.S. corporations are not subject to capital gains tax upon the disposition of stock *except* where that company holds the requisite percentage of U.S. real property. Moreover, due to the complexity and in many cases uncertainty of determining whether the specified percentage

is achieved, many U.S. corporations cannot determine with confidence whether FIRPTA applies to ownership of their shares, leading to confusing public disclosure, inefficiency and wasted resources, and inadvertent noncompliance. U.S. corporations in a variety of fields, from hotel chains to oil and gas companies, as well as other real estate companies, are therefore less attractive investments to foreign purchasers than, for example, U.S. computer software companies. This limits the universe of potential foreign buyers of, or investors in, U.S. corporations with a real property-based business.

In the absence of reform, potential foreign investors in U.S. corporations holding U.S. real estate may, in light of the application of FIRPTA to their eventual disposition of such interests, continue to invest elsewhere – either in real property in countries with less onerous tax regimes, or in other types of U.S. corporations. This preference for other U.S. assets is evidenced by the percentage of certain types of U.S. assets held by foreign investors – 49 percent of U.S. government securities and 16 percent of corporate stocks are held by foreign investors, while only 5 percent of commercial real estate is held by foreign investors.

As stated above, and will be stated again, the U.S. commercial real property market needs an infusion of equity at this time, not a tax regime that deters foreign investment.

C. FIRPTA leads to an inefficient allocation of resources

FIRPTA leads to inefficient allocations of capital by foreign owners of U.S. real property. Given the tax burden faced upon disposition of such property, foreign holders of U.S. real property may be overly influenced by U.S. tax considerations when deciding when to sell their U.S. real property interests or how long to hold them. Capital that might be more effectively put to use via other investment opportunities thus remains locked in U.S. real properties. Moreover, U.S. real properties that might be put to a more productive use in the hands of other owners are unavailable to prospective buyers.

In addition, FIRPTA is a highly complex provision, with internal inconsistencies that can lead to very different tax results from minor differences in transactions. Foreign companies allocate excessive amounts of time and resources to intricate tax-planning and restructuring, rather than productive business activity, in order to avoid tripping FIRPTA. Companies that spend such significant amounts of time and money on FIRPTA planning generally can plan around FIRPTA. In this way, FIRPTA has been reduced to a trap for the unwary – only the unsophisticated or poorly advised end up paying FIRPTA taxes, although significant sums are spent in avoiding it.

D. Inequalities in the Code addressed by the U.S. real property holding corporation provisions of FIRPTA no longer exist

The legislative discussion surrounding the enactment of FIRPTA focused on the perceived need to prevent foreign investors from enjoying a tax advantage over U.S. investors when investing in U.S. real property. Specifically, the legislative history considered transactions in which a foreign investor could enjoy net basis taxation on income from an interest in U.S. real property, and then avoid capital gains upon the property's disposition. Prior to 1986, a U.S. corporation holding U.S. real property could sell the property and liquidate within a year of the sale. Under old section 337, the corporation would not recognize gain on the transaction (the "General Utilities doctrine"). Shareholders recognized capital gain on the liquidating distribution,

but this gain was considered to be with respect to their stock. A foreign investor would not be subject to tax on capital gain arising from disposition of the stock, so the gain in the underlying real property sold prior to the liquidation escaped the U.S. tax system altogether. This concern motivated Congress to tax gain on the sale of shares in U.S. corporations holding U.S. real property and to disregard the Treasury statement advising *against* the implementation of such a tax.

Subsequent to FIRPTA's enactment, however, old section 337 was repealed. Under current law, a corporation is required to recognize gain on the sale or distribution of property upon liquidation as though it had sold the distributed property for fair market value, thereby ensuring that U.S. tax is imposed on the gain inherent in the underlying real property. In other words, as a result of the repeal of the General Utilities doctrine, any gain from a liquidation is taxed twice: once to the liquidating firm and again to the stockholder. Thus, with the repeal of the General Utilities doctrine, the primary tax policy concern justifying U.S. taxation of gain on the disposition of an interest in a U.S. real property holding corporation is no longer relevant.

E. Summary

FIRPTA is an anomaly in the pattern of U.S. taxation of foreign investors; with a few technical exceptions, FIRPTA is literally the only major provision of the U.S. tax code which subjects foreign investors to taxation on capital gains realized from investment in U.S. assets. As described above, FIRPTA acts a significant deterrent to investment in U.S. real property corporations, the costs of compliance are prohibitive, and the policy justifications behind FIRPTA's enactment are no longer relevant. In sum, FIRPTA is an idea whose time has come and gone, and, were it fiscally feasible, should be abandoned in its entirety.

The Roundtable recognizes, however, that budgetary constraints may make it difficult to repeal FIRPTA at this time. Reasonable, cost-efficient reform is still possible, and the Roundtable strongly urges steps be taken to address the negative effects of FIRPTA and ameliorate the current pressure on the U.S. commercial real estate market.

III. Reasonable Steps May be Taken to Increase Foreign Investment in U.S. Real Property

The Roundtable wholeheartedly supported the FIRPTA reform measures proposed in H.R. 5901, the Real Estate Jobs and Investment Act of 2010, which passed in the House of Representatives last July by a vote of 402-11, and currently supports proposed legislation being promoted by Congressmen Kevin Brady (R-TX) and Joe Crowley (D-NY). The Brady/Crowley legislation proposes cost-efficient FIRPTA reform that will encourage foreign investors to significantly increase their ownership of U.S. real property through REITs by expanding certain limited exceptions to the application of FIRPTA, and by providing clarity regarding the U.S. tax treatment of REIT liquidating distributions.

A. Expand the 5% Shareholder Exception to 10% Shareholders in a REIT

Presently, a foreign shareholder owning five percent or less of a publicly-traded U.S. real property company, including a REIT, is exempt from FIRPTA on a sale of the corporation's stock. In addition, a foreign shareholder owning 5 percent or less of a publicly-traded REIT is exempt from FIRPTA on the receipt of a capital gain distribution attributable to the sale or

exchange of a U.S. real property interest. Such a foreign shareholder treats all dividends from the REIT as ordinary dividends. If a REIT dividend to a foreign shareholder is treated as ordinary pursuant to the 5 percent shareholder exception, the U.S. tax rate applicable to the dividend is determined with reference to the U.S. tax treaty relevant to the foreign shareholder. Under many U.S. tax treaties, if a foreign shareholder in a REIT owns 10 percent or less of the REIT, the foreign shareholder is eligible for a reduced treaty rate, typically 15 percent, on REIT ordinary dividends.

Increasing the FIRPTA small shareholder exception from 5 percent to 10 percent shareholders in REITs would attract significant new investment into the U.S. Many overseas investors considering global real estate investments currently limit their investments in the U.S. to remain within the 5 percent FIRPTA limitation. For example, there are billions of dollars invested in funds benchmarked to global real estate indexes for which the U.S. represents roughly a third of the total global index. Many of these funds refrain from investing more than 5 percent in any REIT and losing the benefit of the exception, and thus are underweighted in the U.S. with less than one third of their capital invested in U.S. real estate. Increasing the 5 percent exception to 10 percent would allow these funds to shift their global real estate allocation and directly increase their exposure to U.S. publicly-traded REITs.

Under a few U.S. tax treaties, foreign investors investing in U.S. REITs through certain widely-held, publicly-listed, treaty-recognized mutual fund-type investment vehicles are also eligible for the 15 percent reduced treaty rate on REIT distributions. To be consistent with U.S. tax treaties, the proposed reform clarifies that the exemption applies to foreign investors investing in U.S. REITs through such treaty-recognized mutual fund-type investment vehicles. These investment vehicles are similar to our mutual funds - they are widely held by small foreign investors and provide a means for such investors to invest in U.S. REITs through a familiar, local entity. The U.S. tax treaties look through these vehicles because, as the U.S. Treasury Technical Explanation discussing one such provision states, "*the tax benefits [of investing in an investment vehicle] are intended to replicate the tax treatment of direct investment by these unitholders.*" To ensure equal treatment with investors investing directly in a U.S. REIT, a foreign investor investing in a U.S. REIT through a mutual fund-type investment vehicle would only be eligible for the FIRPTA exemption if the foreign investor owned 10% or less of the REIT. If a foreign shareholder owned more than 10% of a U.S. REIT (either directly or through a mutual fund-type investment vehicle), the investor would be subject to full FIRPTA withholding on REIT distributions and on sales of the REIT stock.

B. Clarify that REIT Redemptions and Liquidating Distributions are Sales of Stock

IRS Notice 2007-55 (the "Notice") presents another obstacle to foreign investment in U.S. commercial real property, and should be repealed.

The IRS asserted in the Notice that REIT liquidating distributions to foreign shareholders should be treated, to the extent attributable to gain with respect to U.S. real property, as capital gain distributions subject to FIRPTA. The Internal Revenue Code specifically states that amounts received by a shareholder in a distribution in complete liquidation of a corporation "shall" be treated as in full payment in exchange for the stock. Until the issuance of the Notice, there was no reason for foreign investors to believe that liquidating distributions by REITs, as with the liquidating distributions of any other corporation, should be treated as anything other than as sales of stock. Needless to say, the IRS' position has caused considerable consternation

in the foreign investor community and has severely constrained continued foreign investment in U.S. real estate.

The Notice also creates distinctions in tax treatment between REIT shareholders in economically parallel positions. For example, a REIT's liquidating distributions to its domestic shareholders are treated as sales of stock, while those to its foreign shareholders are treated as sales of assets (and hence subject to FIRPTA). Nothing in section 897 authorizes the IRS to recharacterize a sales transaction in order to achieve a different tax result for foreign investors. This dichotomy of tax treatment both discourages foreign investment in the U.S. and is without policy justification, as liquidating distributions are the economic equivalent of a shareholder selling all of its stock in the REIT. The Tax Section of the American Bar Association in a June 2008 report concluded that the Notice is insupportable and found little legislative basis for the position taken in the Notice. The report concludes that the Notice should be repealed and that, consistent with the treatment of a U.S. shareholder, "a foreign shareholder's gain on a deemed sale of REIT shares pursuant to a liquidation or redemption ought to be taxed under the FIRPTA rules that apply to stock sales."

There is nothing abusive behind the repeal of the Notice – investors in a domestically-controlled REIT can currently sell their REIT stock prior to a liquidating distribution and avoid FIRPTA. Likewise, sovereign wealth funds can avoid U.S. tax on their REIT investments by limiting their investments in U.S. REITs to a minority position and then selling their investments prior to the REIT making a liquidating distribution. The Notice simply creates an arbitrary distinction in the U.S. tax treatment of a foreign investor depending on whether the foreign investor exits its REIT investment immediately prior to the REIT's liquidation or pursuant to the REIT's liquidation.

With the Notice outstanding, foreign investors are now uncertain regarding the potential U.S. tax burden that may be imposed on gains from investments in U.S. real estate. They are therefore hesitant to invest more equity in U.S. real estate, particularly in non-gateway markets where the anticipated return from investments lies in appreciation of the property rather than operating cash flows. Repeal of the Notice would thus help the neediest markets most – foreign investors would return to REITs investing in smaller market properties, armed with greater clarity as to the U.S. tax treatment of the anticipated capital gains from their investment.

The proposed reform clarifies that the historic understanding of the treatment of REIT liquidating distributions as sales of stock remains unaltered. By overturning Notice 2007-55, the U.S. government would be viewed by foreign investors and sovereign wealth funds as promoting tax policies that are efficient and effective in integrating the corporate and individual tax regimes with respect to real estate investment, allowing a broader class of investors to invest in real estate, giving real estate principals greater access to capital, promoting both capital export and import neutrality, and expanding the push toward territorial taxation in a controlled fashion to include passive-type investment in real estate.

IV. PROVISION OF GUIDANCE REGARDING THE APPLICATION OF SECTION 864(b) WILL ENCOURAGE GREATER LENDING INTO THE U.S.

The Roundtable also urges the Subcommittee to direct the U.S. Treasury Department and Internal Revenue Service to issue guidance to foreign investors with respect to lending activities into the U.S.

The application of U.S. federal income tax to foreign investors generally depends on whether the investor is engaged in the conduct of a trade or business within the United States. If the investor is not so engaged, U.S. tax generally is imposed only on certain enumerated categories of U.S. source income (e.g., dividends on U.S. stock, certain categories of interest income, and capital gains on certain forms of equity investment in U.S. real estate). In contrast, if the investor is engaged in the conduct of a trade or business within the United States, the U.S. imposes a regular income tax on that portion of the investor's worldwide income that is "effectively connected" with that trade or business.

The Code, however, does not contain a comprehensive definition of the term "trade or business." While loan origination is understood to constitute a trade or business, many foreign investors struggle to structure their investments in U.S. debt so as to avoid being treated as having originated a loan, even where they are clearly acting as passive investors. Investors seek to satisfy the safe harbors provided in section 864(b) of the Code for proprietary trading by non-dealers in stocks, securities and commodities, and thereby avoid being treated as engaged in a trade or business, but there is significant uncertainty as to how exactly to qualify for the safe harbors.

For example, in an effort to fit within the safe harbors, many foreign investors seeking to invest in U.S. debt arrange to acquire U.S. debt from a U.S. bank only after forty-eight hours have passed from the time the U.S. bank has originated the loan. Some foreign investors also believe that the commitment to acquire the loan must be conditional so as to avoid treatment of the U.S. bank as an agent of the foreign investor. Yet the conditionality required to give the investor comfort for tax purposes may not be commercially viable, leaving foreign investors in a quandary, seeking to balance the effort to invest in U.S. debt with the uncertainty as to whether that investment will cause the investor to be treated as engaged in a U.S. trade or business. Moreover, this position has never been sanctioned by the IRS. The absurdity of the situation is made more apparent when compared to the relative lack of complication foreign investors face when investing in publicly-issued debt in the U.S., which most foreign investors are comfortable acquiring at the original issuance. Both forms of investment are passive investments in debt of a U.S. borrower for the foreign investor, and should not require different structuring machinations.

In addition, foreign investors are limited in their ability to buy U.S. distressed debt; for fear that a subsequent restructuring of that debt will render their participation in the restructuring equivalent to a U.S. trade or business. With the excessive amounts of distressed debt circulating in the credit system at present, providing guidance to potential foreign investors in that debt should be a top priority of the of the Treasury Department and the IRS.

The provision of "guidance on lending activities under section 864" has been on the IRS-Treasury business plan since August 2006. The IRS has been repeatedly petitioned to provide guidance, but none has been forthcoming. As a result, foreign investors with substantial capital that could be made available to ease the credit shortage in the U.S. are currently unwilling to do so, in large measure because of the tax uncertainty created by the continuing absence of definitive guidance as to the scope of the safe harbor for proprietary trading in securities. In these circumstances, counsel to foreign investment funds have frequently concluded that many of the types of transactions that are now prevalent in the U.S. credit markets simply involve too much tax uncertainty, particularly as many foreign investment funds represent to their own investors that they will not engage in activities that would be treated as a trade or business and expose them to U.S. taxation on a net income basis. As a result, transactions that would add significant

liquidity to the U.S. credit markets and provide long-term benefits to the U.S. economy – purchasing loans on the secondary market and, where applicable, participating in restructuring of those loans and other securities – are not being undertaken.

In light of the ongoing constraints on the availability of credit in the U.S., and changes in the lending-related practices of banks and other loan originators, the Roundtable urges the members of the Subcommittee to direct the Treasury Department and the IRS to issue guidance as soon as possible setting forth a series of safe harbors that would reflect current practices in the U.S. credit markets and permit foreign investors to invest in U.S. debt with confidence as to the U.S. tax results of that investment.

CONCLUSION

In conclusion, the commercial real estate market in the U.S. faces unprecedented challenges. There are tools available, however, to assist the market in recovering from the difficulties of the past few years. Taking simple steps to encourage greater investment in U.S. real property and U.S. debt securities will provide the investments needed by the commercial real estate market to avoid foreclosures, maintain and upgrade existing properties, develop new real estate projects and employ the thousands of people dependent on this vital sector of our economy. Now is the time for action. Now is the time to enact simple changes that will make a dramatic difference in the U.S. commercial real estate market.

Chairman TIBERI. Thank you to the entire panel. Very good testimony.

Question one is for the entire panel, and I will start with Ms. McLernon. What advantages do you see, from where you sit, do foreign entities have to invest in the United States? And what are the disadvantages that the U.S. has for foreign entities to provide capital and invest?

Ms. MCLERNON. Thank you, Mr. Chairman. What advantages do foreign companies have? Let's go with that one first. I think foreign companies——

Chairman TIBERI. Not advantages that they have. What advantages are there for foreign entities to invest in the United States——

Ms. MCLERNON. Okay.

Chairman TIBERI [continuing]. And what are the disadvantages for a foreign entity to invest in the United States?

Ms. MCLERNON. What I hear time and again from my member companies, in terms of the reason to invest in the U.S., certainly the size of our economy is a main reason for companies to invest. When choosing amongst a number of different countries, it is the quality of our workforce that comes up time and time again as the main reason for encouraging investment here.

We have talked on the panel about some companies that have global operations here in the U.S. So those are the operations they can really place just about anywhere, and they are choosing to place here. And again, it is the quality of the workforce that I am hearing.

However, I am also hearing that there is a concern about that quality going forward. Our investment in the ability to maintain a skilled workforce in the years ahead, I think, has been raised to the top level of concerns for our companies. They manufacture here at the very high end. And so those are the types of workers that they are going to look for here, because that's where it makes sense, where the U.S. can have a competitive advantage. So, I would say that that is one of the reasons that these companies come here.

In terms of disadvantages, specifically for my unique slice of the business community, certainly within the tax area, the one issue that, in addition to FIRPTA that was mentioned earlier, is the 163(j) provision in our Tax Code, which is inherently discriminatory, only impacts practically the U.S. subs of foreign companies. And it inhibits their ability to expand and grow here by the way in which—that these companies are restricted from borrowing from their parent company or borrowing from a third party with a parent company guarantee.

So that is the provision in our Tax Code that does provide some disincentives to these firms, in terms of being here.

Chairman TIBERI. Mr. Spitzer.

Mr. SPITZER. Sure. Nestle invests in the U.S. And we are a food company, obviously, so, food costs, transportation costs of moving food from Europe to the U.S. are very expensive. So we go where the market is, where our consumers are, where natural resources are, workforce, et cetera.

But I think some of the disadvantages—I have to echo Nancy's comments about restrictions on the ability to deduct interest and borrow. You know, we align our expenses with our profits. So if we have expenses related to an investment in a factory or a business here, the interest expense that goes with that profit should be aligned. We align for basic economic reasons, for exchange control reasons. In other countries, if we are concerned about expropriation or political unrest, we align profits and expenses. And interest is just a general expense of doing business anywhere.

So, restricting an inbound investment artificially, as compared to an investment by a U.S.-headquartered company, is a disincentive.

And further restrictions on interest deductions would be even a greater disincentive to invest here.

Another disincentive is that most U.S. companies are on the U.S. exchanges. Nestle is not. So, for us to use our stock in an acquisition, it is almost impossible. So we have to do it with cash, and we do all our acquisitions with cash. So, once again, interest becomes a more important element of that acquisition.

So, there are substantial disadvantages for a foreign company trying to come in and invest in the U.S.

Chairman TIBERI. Thank you. Sir.

Mr. DRAILLARD. Well, for Dassault Falcon Jet, investing in the United States was primarily being close to our customers. The United States is still the number one market for business aircraft, in number of units, by far. Other countries are emerging, but the United States is still the primary source of new orders for us and for all the major players in this industry.

The other advantages, as Nancy was talking about earlier, was certainly the skill of the workforce. But we see—and we dramatically see it since, I would say, 2006—a decrease in the level of the workforce. We are finding locally, especially in areas like the center of the country and the southeast of the country, we have more and more trouble finding local people that have the skills we are looking for a high-end, high-technology industry.

As far as we are talking about disadvantages, disadvantages are mostly in our export efforts. The lack of tax treaties between the United States and other countries sometimes hinder us from basically growing our business and getting the fruits from our efforts and exporting U.S.—well, mostly U.S.—manufactured goods. Even though we are owned by a French company, 60 percent of the airplanes we are selling has U.S. content.

Mr. DEBOER. It is hard to imagine something more disadvantageous than a 54 percent exit tax on an investment in U.S. real estate. My statement has details on that.

But on top of that, I would say that the investments that do come in create a tremendous misallocation of resources for American investors seeking to partner with foreign capital sources, because the structures that need to be assembled to make these investments occur at any level require a tremendous amount of tax planning and a tremendous amount of resource allocation that should be going somewhere else, and could be put to a more productive use.

I would like to also highlight, in addition to this FIRPTA issue which, again, affects investment in U.S. real estate on an equity basis—and we need equity to rebalance these loans—but think about the debt situation.

We have a tremendous amount of commercial real estate debt that is, essentially, under water and needs to be restructured. This troubled debt, if it is acquired by a foreign capital source, foreign capital sources have to worry about being deemed to be in the trader business here in the United States. And so they are very hesitant to make these investments, because they don't know quite what the guidelines are from the Treasury Department. This has been on their business plan since 2006. They have been petitioned by a wide array of actors in this area to make guidelines and safe

harbors more clear for investors. And so I would urge that that also be looked at.

Chairman TIBERI. Last question for the entire panel, as well, and we will start here on this side, with Mr. DeBoer.

In addition to your comments about FIRPTA, is there anything specifically in the Tax Code, the current Tax Code, that makes it less likely to see foreign capital, foreign investment, foreign companies to come into the United States? And if you could, elaborate in addition to what you have already elaborated on FIRPTA.

Mr. DEBOER. Well, again, I think that, as has been stated, we are in a global economy. And so it's not always just what is in our tax law, but it is what is in other countries' tax laws. And the way other nations treat real estate investment is much different than the way that our nation treats real estate investment. So, in addition to this barrier that we have, we look at it as a barrier compared to what other nations have, and we see it to be highly discriminatory here.

So, I guess I would leave it at that.

Mr. DRAILLARD. I would tend to agree with what has just been said. On top of that, I would say that the earnings stripping is probably one of the biggest problems that we see not so much ourselves, but our customers.

Mr. SPITZER. Yes, I think 163(j) is the biggest impediment. But also debt equity issues. I mentioned that the IRS, the administration of the law by the IRS, concerning inbound companies. And debt equity is another way of disallowing interest deductions.

And I also think—Nestle is a very large company, obviously. We are big boys, we can handle ourselves with the regulations and the IRS. But if you want to attract medium and smaller foreign businesses into the U.S., I think the general complexity, uncertainty, and the administration of the law are barriers to inviting mid-sized and smaller investments. And I think that's a very important point to make.

I know in the transfer pricing area, for example, we have been to court now three times on our royalties. Our business model is, like many U.S.-headquartered companies, to maintain our intellectual property in our home country Switzerland. It is less expensive to do, because of the synergistic nature of it. So trademarks, R&D, et cetera, and we charge out globally for it, in the form of royalties for both trademarks and R&D, although we conduct a lot of R&D here.

So dealing with the IRS on these issues, we have had battles with them, we have gone to court three times, went to trial once, summary judgment once, and then a settlement once. And trial, summary judgment we won 100 percent, settlement we won well over 90 percent. So, the bottom line is, even when you are right, it is very expensive to deal with transfer pricing issues.

The same thing on debt. We went to court on debt equity issue in trial back in the 1990s. We won 100 percent. But for a large company like Nestle, we can do it. We have the resources. It is not pleasant. But for medium sized and small companies, it is daunting. And once you have that reputation out there as a difficult place to invest in, it is very hard to bring investment in.

I know the states are out there, encouraging European companies and Asian companies to come in. I don't think the U.S. does anything like that. And maybe the U.S. should do something like that.

Ms. MCLERNON. Mr. Chairman, I will just go ahead and make it—get it out onto an even more basic level. I think the rate is an impediment. And our companies, just as Nestle explained, sometimes when the congress passes a provision that they expect can be helpful, in terms of the rate, like an R&D tax credit, which can be very helpful, the way that the IRS administers that is not reliable.

And I have had one of my CEFOs from one of my companies say, "I cannot count on that. We have been litigating it for 10 years," even though they do a lot of R&D here. "So, I think of—when I am thinking of investing in the U.S., I think of the rate, and I throw that up on the white board, and that is what we look at."

So, you know, boiling it down to its most simple level, I would say that the rate itself was a big impediment.

Chairman TIBERI. Thank you. I will recognize the ranking member, Mr. Neal.

Mr. NEAL. Thank you very much, Mr. Chairman. There is very little that has been offered by our panel that I would find myself in disagreement with. But I think that we use this process to enlighten, as well.

Mr. Draillard noted that many companies—many countries offer incentives to secure investment. But I think it bears noting as well that we have got some pretty stubborn problems ahead of us here in America, not the least of which is paying for the war in Iraq, a VA system that is sure to be stretched for the next 50 to 60 years for the 31,000 men and women who have served us with great honor over these years, and, let us be candid, not a bad deal for our European friends under the umbrella of what we call NATO. They have spent about one percent of their GDP since the end of World War II on national defense, and the American taxpayer and the American soldier has pretty much been in a position to foot the bill. That is part of the consideration.

Now, I want to say to you that corporate tax reform needs to be changed, and it certainly does. And the hearings that Chairman Camp and others have offered are certainly instructive, and hopefully will take us in a new direction. But not to miss the point that there are some serious obligations that America has, going forward.

And, as part of the process of the hearing, it strikes me that we need to note those obligations and understand clearly that, as I indicated a couple of moments ago, I think the American taxpayer has been pretty generous with the defense that they have provided to the rest of the world, and frequently point out to critics of America that the reason that many of our friends across the globe are not speaking a different language, it is because of the American taxpayer and the American soldier. We provide that umbrella of protection for much of the rest of the world.

And Secretary Gates, to his credit, has put it forward once again, as I did probably 20 years ago, in discussions that, at the same time, we are looking at some structural deficits that were significant.

Now, Ms. McLernon, you indicated—and I would like to hear from the other panelists, as well—the R&D credit. That is a big deal for Massachusetts. We are, despite the fact, a medium-sized state—some might consider it a small state—we rely heavily upon that R&D credit, largely because of the technology and, let's be candid, because of the people that we attract in Massachusetts to live on cutting edge opportunities.

So, how might you suggest that we do a better job, one, with predictability, as it relates to the R&D credit, because I think you are entirely correct, that you cannot, from year to year, wonder if it is going to be around, or wonder what the rate is going to be? And, at the same time, how would you suggest that we do a better job of administering it beyond just that issue of predictability?

And we can move to the other panelists, as well, after you.

Ms. MCLERNON. Okay, thank you. All the points that you just stated, I absolutely agree with. And while the intent of Congress is to put this in place to encourage more R&D in the U.S., I think the IRS has sort of hijacked it. It has become an issue that is always investigated very heavily at the IRS. And companies—pharmaceutical companies, in particular, who—you would think research means research means research; it doesn't always turn out that way.

And by being able to convey more appropriately what the IRS should be doing, and what Congress's intent—perhaps could be helpful, because it is not getting, I think, what you want it to be, because of the uncertainty that not only the non-permanent nature of it, but how the IRS is looking at it.

Mr. NEAL. Thank you. Mr. Spitzer, you also owned that very famous company in Massachusetts, Friendly's, for a period of time.

Mr. SPITZER. Actually, I think that was Hershey.

Mr. NEAL. Oh, Hershey. I stand corrected.

[Laughter.]

Mr. NEAL. But you wanted to.

Mr. SPITZER. Yes. We have—I know in Massachusetts we have a water company, and we just started a new business, Tribe Hummus, which is manufactured up in Massachusetts.

Mr. NEAL. Right.

Mr. SPITZER. So—and my son was going to school up in Boston. So I love Massachusetts.

But I have a little radical view on some of these things. The U.S. Tax Code is so complex and so difficult. And I think one of the reasons is we try to do so many things with it. It is not just a revenue raiser. We try to do political things, economic things, incentives. And if we could give incentives in a different way that does not involve the Tax Code, then we won't have the IRS auditing in such a way that it becomes so difficult to achieve those incentives.

If we could give out grants of some sort—I know it is—politically difficult, but it does create a real problem in trying to actually take advantage of the things that the government wants to give us to promote businesses.

But I just want to add——

Mr. NEAL. Please.

Mr. Spitzer [continuing]. Nestle's R&D exceeds every other food company in the world. I think about 1.3 percent of our sales is the amount we devote to R&D.

Mr. NEAL. Yes.

Mr. SPITZER. Which is huge.

Mr. DRAILLARD. As far as R&D tax credit is concerned, our main concern is the definition of R&D. And here we need, nonetheless, stability, but more visibility on this definition, more clarity on this definition.

R&D means research and development. And development is not fully defined in the U.S. Tax Code. And this hinders us from a number of issues—if we could actually—we thought were eligible for tax credit, like first of a kind installation. When you install for the first time a brand new system on a new airplane that hasn't been installed ever before, and it is actually manufactured in the United States and installed for the first time in the United States, this is not eligible. And this is troublesome.

Mr. NEAL. Mr. DeBoer.

Mr. DEBOER. Mr. Neal, clearly we need to pay for our wars. We support—I agree with everything that you said. In the case of real estate investment, I guess I would say don't you find it astounding that America, where everyone wants to live and invest, has now slipped to third, globally, in terms of the chase for global funds for real estate, behind the UK and Germany? I find that astounding.

And, in terms of revenue—and I think that is where you are going on this—who, really, is paying the FIRPTA tax? What kind of foreign investor is actually paying a 54 percent exit tax here? Not very many. And so, if you lower that—effectively—tariff, you are going to bring in more capital, you are going to create more jobs, you are going to stabilize communities and ease up on some of the problems in our local community banks. So that is sort of where we are coming from on this.

Mr. NEAL. In some of the hearings and discussions that we have had, and I have had back home, I still have not been able to get clarity from many corporate leaders on the issue of the R&D, however. When I have asked them if they were to get a 28 percent or 27 percent corporate rate, would they be willing to give up R&D, a great deal of uncertainty.

Thank you, Mr. Chairman.

Chairman TIBERI. Thank you. I recognize the gentleman from Illinois, Mr. Roskam.

Mr. ROSKAM. Thank you, Mr. Chairman, and thank you for all four panelists, for your testimony this morning. It has been helpful and instructive.

You know there is people that are involved in the public debate on this issue—I don't think anybody that is present here today, in terms of members—but there is a sub-text, as it relates to foreign investment, and that is this, that people think—I would say uninformed people would think—that you are going to invest in the U.S., no matter what, that there is the imprimatur of the U.S., and sort of the worldwide reputation and so forth, that no matter how bad things get here, you are still going to come. I think that is actually a dangerous way of thinking. I don't think it is true.

Can you walk us through—you each mentioned different components in your testimony, you know. Ms. McLernon, you said that the U.S. share has dramatically declined over the years. Mr. Spitzer—and I am paraphrasing, just jotting down notes from your testimony—you said the rest of the world is moving to a lower tax rate, and the U.S. should, too. Mr. Draillard, you said that the U.S. is no longer a growing market, and investors are beginning to question whether this is really where the action is—those are my words and not yours, but I think that was your theme—and then, Mr. DeBoer, you were basically making the argument, you know, essentially, why should capital come here.

Can you give us the—a sense of what it is that companies and foreign investors are looking out over the global landscape? What is attractive? What are the things that you are looking for? You mentioned predictability, and so forth, but what are the things that you are looking for that the U.S. can emulate? And who are we competing against? And what is the nature of that competition right now? Let us start with you, Ms. McLernon.

Ms. MCLERNON. Thank you very much, Congressman. You are absolutely right, in terms of the U.S. has always thought that global companies were going to come here because we were the "it" country, and this was the place to be. The numbers that are now available don't support that, even though foreign investment from 2009 to 2010 went up, because it was down so low in 2009.

As I indicated, our share is really dropping, precipitously. And that is for a variety of reasons, some of which outside our country. Other countries are aggressively marketing to get this investment. I think that is one of the reasons that the Administration announced an effort last week called Select USA, which is going to try to actively recruit, among other things, foreign companies to the U.S. So, I think that there definitely is some evidence that we are losing our ability to do it.

From my membership perspective, tax policy certainly is a factor in determining investment. But I would also add that a skilled workforce, as I mentioned earlier, as well as infrastructure investment, is quite important, as well. The ability to move people, product, and information is critically important, and especially when companies can really locate their global operations anywhere to serve the world.

They are not only operating them out of their home country. As I mentioned before, there are several U.S. or foreign-based multinationals that have their global operations for certain divisions here in the United States. But in order to attract that, we need a smart, skilled workforce and a strong, sound, state-of-the-art infrastructure system, as well as a transparent, non-discriminatory Tax Code with a lower rate. Those are the things that I have heard prioritized from my membership.

Mr. SPITZER. Sure. I think we have a few employees in your district in our candy factories there, well over 1,000.

Mr. ROSKAM. Don't you dare go to Ohio or Massachusetts and shine any apples this morning.

[Laughter.]

Mr. SPITZER. Well, we have some things in Ohio, as well.

But if we are going to be in this country, producing products, I think the competition, from our perspective, would be Canada and Mexico, where we can easily put a plant up in Canada, or put one in Mexico, and bring the products in.

And so, if we have more restrictive problems and ability to deduct our business expenses, either at a federal level or a state level—and let me just make a couple comments about the states, which I already did—some of the provisions in the states are so perverse, that they actually—if you make investments here, then they try to bring in your foreign affiliates into the country, which is just the opposite of what you are trying to do. You want to encourage investment, not discourage it specifically. So, whatever the committee can do to encourage or discourage this kind of behavior will be helpful.

But within Nestle, we have investments all around the world in 140 or so countries. Nestle in the U.S. competes with these other countries for the capital to make investments. So, if the profits look better in some other country, a developing country or wherever, we are going to put our capital where we think we can make the most money. And so, the more restrictions on our ability to earn money here will obviously sway the investment decisions to other markets. And so we have to be very thoughtful about this.

Mr. ROSKAM. Mr. Draillard.

Mr. DRAILLARD. Mr. Congressman, I think you got my theme right. We are going where our customers are. And our customers, even our U.S. customers, are going everywhere.

So, what is attractive was your first—the first part of your question. What is attractive is where can we sell airplanes. What is attractive is where can one find workforce that we can bring in to any of our facilities, either in the United States or in France.

What is attractive is also the protection of our technology. We are—hopefully still—number one in the high end of the business jet market. And the reason for that is our edge in aviation, in aerostructures, basically. And we need skills for that. And we need to protect that know-how. And stability of the political structure is one of the biggest factors we look at.

Tax, in that effect, we see tax as part of the stability of political structures in the economic environment. And, therefore, even though it may not be a deal-killer, the tax rate is something we definitely look at.

Mr. DEBOER. Foreign investors are looking for the same things in real estate that domestic investors are looking for. They are looking for current income streams, and, more importantly, they are looking for capital gain on the outside. So the tax policy, particularly relating to the capital gain—and that is where FIRPTA affects things—is very, very important.

On top of that, I think what was previously mentioned about transportation, infrastructure, the ease of these foreign investors to come in, see their investments, visit the United States, is very, very important. And those are other policies, aside from tax policy, that are very important.

As far as competitors, I mentioned the UK and Germany. But also, global capital flows are going tremendously into Brazil, into China, into India. It is no surprise. And again, for those invest-

ments, it is not for the steady income stream right now, but it is for the value add and the capital gain that will come later on.

Mr. ROSKAM. Thank you. Thanks, Mr. Chairman, I yield back.

Chairman TIBERI. The gentleman from Minnesota, Mr. Paulsen, is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. And I just want to follow up a little bit on the discussion about research and development just for a second, because I think you identified how your companies, your membership in your companies, as a part of the testimony, it is such an important component of jobs here, of economic development. And I just want to expand a bit.

Can you just share some thoughts about why that is so important? I do understand, working with the med tech industry, in particular, that the incentives to attract research and development are much stronger in other countries than they actually are here, in the United States. What actually happens when R&D is actually conducted here, in the United States?

What types of jobs are we talking about, whether it is in the food industry, whether it is in med tech or other membership companies? But can you maybe just elaborate a little, Ms. McLernon?

Ms. MCLERNON. Yes, absolutely. Our companies produce about 14 percent of private sector R&D. So it is an important part of what we do here, and we contribute a lot to the U.S. R&D base.

Much of the reason that our companies do R&D here—I think we have talked on—is the quality of the workforce. It is also access to universities. But these are high-end jobs. Because we create 14 percent of research and development, it leads back to the fact that our companies pay 30 percent higher than average company. And this is because it conveys the higher-level, high-skill nature job that these companies tend to support, in scientists and engineers.

And so, I would say that research and development, when it happens here, especially with using American scientists and engineers, the U.S. economy benefits. I think many countries around the world, including the U.S., are actively trying to recruit that R&D. And the U.S. has done a pretty good job, considering other countries are actively working in this area.

Mr. PAULSEN. Yes. So it is safe to say—Mr. Spitzer and Mr. Draillard, please comment, too—but it is safe to say where the innovation starts, where it occurs, is where you are going to have sort of the supply chain, if you will, of other follow-up——

Ms. MCLERNON. Yes, there is certainly——

Mr. PAULSEN [continuing]. progression of other jobs.

Ms. MCLERNON. There is certainly a multiplier effect, if you will, of R&D investment.

Mr. PAULSEN. Right, right.

Ms. MCLERNON. Absolutely.

Mr. PAULSEN. Mr. DeBoer, I am going to just change themes here real quick, before my time runs out. But Mr. DeBoer, you talked about modifying FIRPTA as a part of your testimony, to encourage greater foreign direct investment in U.S. commercial real estate space here in the United States.

And I think when a lot of people think of commercial real estate, they think of Washington, D.C., they think of New York, they think of kind of the big, commercial real estate spaces. But how would

the modification of some of the proposals you are offering or proposing—how would that help midwestern community banks?

Because you sort of alluded that—I caught that in your testimony, also. But how does that help Midwestern community banks—and Minnesota is an example—give more—get more access to credit for small businesses?

Mr. DEBOER. Thank you for the question, because I think a lot of people are confused about how this would benefit markets outside of New York or Washington or San Francisco, which are actually doing reasonably well.

It goes to what I was talking about before. Investors want capital gain. They want to invest in areas where they can see those values come back. As you know, there has been some value decline across the country. Certain markets are hit more hard than other markets. These are areas that need tremendous amounts of equity.

These owners have been essentially hanging on now since 2006/2007-time period, they have been funding the debt service out of their own pockets, out of their own equity. The jobs have not come back, the loans need to be balanced. There is a tremendous amount of these loans that are held by community banks.

Re-balancing these loans will help ease the pressure on the community banks, point number one, which will allow the banks to then be able to lend more of their capital, and devote more of their attention to providing small business loans to American small businesses to create jobs. So, helping ease that side of the balance sheet for community banks would be very, very helpful.

Then you look at the real estate, itself. A lot of these assets have had deferred maintenance on them. In other words, people—they are starting to run down. People are running out of capital. They cannot, you know, tenant them up and put them in the transaction stream and keep their values up. If they can get capital put into them, construction workers will go back to work and architectural firms will go back to work, and transactions will occur so transfer taxes can occur and help communities.

This—in particular, part two of what I talked about, the notice, the IRS notice, this is a situation that would directly help smaller communities, as opposed to larger cities, in attracting investment. That is where foreign capital wants to partner with local owners to recapitalize, reposition these assets. That will be very, very helpful in smaller markets, sir.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you, sir. Before I recognize Dr. Boustany, I want to just note, Mr. Spitzer, that Mr. Neal and I both appreciate the presence that you have of Nestle jobs in our states. And now that Mr. Roskam has left, we are willing to work with you to divvy up those Illinois jobs to Ohio and Massachusetts. So we can talk about that later.

[Laughter.]

Chairman TIBERI. Dr. Boustany is recognized for five minutes.

Mr. BOUSTANY. Thank you, Mr. Chairman. Let me say Louisiana is open for business, so we can talk about this.

You know, this is about economic growth and competitiveness. And as policy makers, obviously we are very concerned about economic growth as part—a major part of the equation to deal with

this high unemployment we have in this country, you know, just the sluggishness, all the problems we are seeing in the news, daily.

And as I reviewed some of the stats that we had in testimony in the written binder here, you know, Louisiana, over 48,000 jobs from foreign subsidiaries, 5.7 million jobs in the U.S., which is basically 5 percent of our U.S. private workforce. Less than 1 percent of U.S. business, yet 17 percent of corporate tax revenue, as Ms. McLernon pointed out. And yet, I think all of you said that we are underperforming, as a country, when it comes to foreign direct investment.

So, one question I have—and I think, Mr. Spitzer, you alluded to this earlier—and that is the indirect jobs that basically are created and sustained as a result of foreign subsidiary activity, do we have actual numbers, or some sort of a sense of the number of indirect jobs here created in the U.S., as a result of direct job growth from foreign subs?

Ms. MCLERNON. As an organization we haven't done that calculation, but absolutely indirect jobs need to be included.

I mean sometimes an investment can absolutely transform a local economy. When Michelin invested in North Carolina, they have transformed that area from a textile industry to one that attracts global investment because of all the different suppliers that came to help serve them. And so, you know, absolutely. Indirect jobs should be part of this.

Mr. BOUSTANY. And given that many of your companies are involved in U.S. exports to foreign countries, and the President's goal is to increase U.S. exports, and linking our small and mid-sized firms into this global market is critically important in that respect—and so it seems to me that this indirect job growth would be something that we would want, from a policy standpoint, but it is also a way of linking our small and mid-sized firms into the global supply chain. Is that a fair statement?

Ms. MCLERNON. Yes. No, I would agree, Congressman. I think that by interacting with globally-engaged companies, it can encourage small and mid-sized companies to get globally engaged.

In addition, sometimes when a company from abroad that has suppliers in its area want to come and help serve that company when it invests in the U.S., actually are incentivized to come and set up shop, employ people here, do a Greenfield investment in order to serve that global company here in the United States.

So, there are a variety of indirect jobs that can come about when a global company invests.

Mr. BOUSTANY. And, Mr. Spitzer, you raised the issue of indirect jobs in the context of what your company does. Do you have any numbers, estimates?

Mr. SPITZER. No, unfortunately, I don't. But, obviously, in the food industry there is third-party packaging, third-party transport, resources, et cetera. So it is—the numbers are huge in our industry, but I don't have the numbers.

Mr. BOUSTANY. So, as a country, given that we are underperforming in attracting foreign direct investment, we are losing ground. It seems to me that, looking at those policies that are having this detrimental impact, and making the kinds of corrections that you have all suggested, would help us with our unemployment

problem, and help us get this country back on a path of sustained and strong economic growth and job creation.

Mr. SPITZER. Oh, absolutely. Yes, of course.

Mr. BOUSTANY. Thank you. All of you have mentioned the complexity. Mr. Spitzer, you focused on this a good bit, and talked about the coordinated effort by the IRS to audit under section 163(j). And I, as the chairman of the Oversight Subcommittee on this full committee, I would be interested in learning more about the problems you have with all that.

Mr. SPITZER. Sure. Actually, it is not 163(j), it is Section 385, which is—it is sort of a debt equity question——

Mr. BOUSTANY. Okay.

Mr. Spitzer [continuing]. Looking to see how much debt you have versus the equity, and looking to see did you dot all the I's, cross all the T's on borrowing from your foreign affiliate, foreign parents.

And you know, as I indicated, there is no—as far as I know, there is no sense that there is actual abuse out there, or any documentation there is an abuse. But it is very expensive to deal with these issues. And, as I said earlier, we had to go to court many, many years ago on this particular issue.

Since then, 163(j) came in, which is a further restriction on the ability to deduct interest. So they still both exist, simultaneously. And the IRS seems to be pushing now this Section 385 debt equity issue.

I want to mention one example of the perverseness of 163(j). We, Nestle in the U.S., can borrow on its own. We don't. Because if we were to borrow on our own, it would cost us more interest.

Mr. BOUSTANY. Yes.

Mr. SPITZER. Which means that we are going to get less back on our investment, which means our investments are going to be smaller. And if we borrow on our own, and pay a higher interest rate, we are going to pay less U.S. taxes.

So, it is very perverse, especially when you are borrowing from third parties with a guarantee of your parent company. So, if I borrow from a U.S. bank, Citibank, and I get a guarantee from our U.S. parent so that we can get a lower rate, it does not make any sense that this should be some sort of tainted interest expense. This is all within the U.S. And we are actually trying to make a larger investment, not a smaller one.

Mr. BOUSTANY. Thank you, sir. I see my time has expired.

But one last comment, Mr. Chairman. You know, we hear a constant refrain about the IRS needing more resources to manage its workload. But at the same time, we are hearing from these folks that the code is so complex that it creates all this additional need for resources, both at the IRS and on the part of these companies, just for compliance. And so we have to tackle this problem of complexity in the Tax Code, as we do reform.

And I yield back.

Chairman TIBERI. Thank the gentleman. With that, I yield to the gentleman from Texas, Mr. Marchant, for five minutes.

Mr. MARCHANT. Thank you, Mr. Chairman. What single piece of legislation that is pending before this committee, this subcommittee or committee, would you think that we should pass that

would have the most immediate positive effect on investment, job creation by your clients or your industry or your company?

Ms. MCLERNON. As of now, I don't—our organization is not focused on a particular piece of legislation that you are currently considering, other than—I don't know if the FIRPTA legislation is part of what this subcommittee is focused on.

So, I would say, in terms of global investment, that would certainly be a piece of legislation that we would support. Generally, on tax reform, again, it is about the lower rate and pushed in a transparent manner that is consistent and non-discriminatory.

Mr. MARCHANT. Mr. Spitzer.

Mr. SPITZER. Sure. I was just down in Texas yesterday, in Austin. So—a great state. We have some water businesses down there. We own Ozarka Water, which is ours.

I don't know all the legislative proposals that are in front of you. Obviously, a lower tax rate is very helpful. All the OECD countries, except for Japan, have a much lower rate than the U.S. does. And Japan is considering lowering its tax rate, as well, below ours. So, we are not competitive on a tax-rate-basis with other developed countries.

Obviously, I have talked about 163(j), and any further restrictions in that area would be very difficult for a company like ours to deal with. And I certainly think there should be some liberalization there concerning third-party borrowings that are simply guaranteed by our parent companies. It just doesn't make sense to me.

A proposal that has been out there is this corporate residency proposal. I think it was sort of directed at inverted companies, which are pretty limited now, and maybe some hedge funds. It's a baby and the bath water situation, in my mind. As I understood the legislation, as proposed here, any decision-making in the U.S., whether it is by corporate officers or not, might bring a foreign company into the U.S. for federal tax purposes.

So, for example—I don't want to pick on Sony, but Sony's chairman, Howard Stringer, spends time in Tokyo, spends time in London, spends time in New York—I think one-third, one-third. If, all of a sudden, under these proposals under corporate residency, Sony Japan woke up and found it was a U.S. company, it would be devastating. All their affiliates around the world would be CFCs. Dividends to the Japanese shareholders would be subject to the U.S. withholding taxes.

And, unlike so many other countries—or few countries—that have these sort of residency requirements, like the UK and Holland, it is very formalistic. The proposals in the U.S. would be very difficult for anybody to deal with. And I think any advisor would have to recommend to their clients, "Get every decision-maker out of the U.S. pronto," because the consequences could be so horrific.

Mr. MARCHANT. Thank you.

Mr. DRAILLARD. Number one would be absolutely the corporate tax rate. Their—simplification is also a big item on our list, just for the reason that it is a layer of fixed cost for most companies. And the smaller the companies, the bigger that burden is, and that hinders them from basically operating and doing business, especially in a state like yours. We have a number of local vendors in Texas that work for our Little Rock, Arkansas, facility. And we see

the burden of just administering federal and state regulations, tax regulations, being so huge. Just complying has become such a huge burden that it is a fixed cost that they cannot basically overcome.

Mr. MARCHANT. Thank you.

Mr. DEBOER. We understand that Mr. Crowley and Mr. Brady are readying legislation to be reintroduced on FIRPTA. We would urge that that be immediately passed. It would have tremendous salutary benefits.

The guts of this legislation is legislation that passed the House in the last congress with 402 votes in support of it. It died in the Senate, but perhaps we can move that—see that action this year.

Incidentally, there is one thing that could be done immediately that would have very, very direct and almost immediate benefits, and that is this IRS notice dealing with how liquidating distributions are treated from private domestic REITs back to foreign investors. That could be done by the stroke of a pen, administratively.

And, again, we understand that some members are looking at urging the Treasury Department to look in this area, and we would absolutely urge you to do that as quickly as possible, and it would have immediate benefits. Thank you.

Mr. MARCHANT. Thank you.

Chairman TIBERI. The gentleman from North Dakota, Mr. Berg, is recognized.

Mr. BERG. Thank you, Mr. Chairman. This is an important hearing; I appreciate all your input.

Mr. Draillard, I—you have got a great plane. And I mean I just think that is unique. If you think about a global business, quite frankly, when you are making jets you can make them pretty much anywhere. And they are going to sell where the economies are the strongest.

And so, you know, I am very interested in kind of—I was interested in your written testimony. And I just kind of want to—I mean, clearly, the number one thing we need to do is have a strong economy. That will help the aircraft industry.

I am a private pilot, so I will never fly a jet, but I am always jealous of jet owners and flyers.

But what are the things that we could do to encourage more jobs to come to America in the aircraft industry? I mean what would be the one thing, from a policy tax standpoint, where, you know, every manufacturer that is not in the United States would say, "Hey, we really need to look at the United States as a manufacturing"—or "a component for our production?"

Mr. DRAILLARD. There are many things we could do. And actually, I am at a loss of where to start, but three main things come to mind.

The first one is federal versus state taxes for structured financing of aircraft. A lot of companies, even very large companies, Fortune 500 companies, finance for different reasons their acquisition of the airplane, probably up to 70 or 80 percent. The structure of the leases or of the asset-backed mortgage that they take against the asset is very cumbersome, from a tax standpoint. And, frankly, from an OEM perspective, I think the only people making money out of it are the tax lawyers.

The other thing we can definitely——

Mr. BERG. I am also a tax lawyer. Teasing, teasing.

Mr. DRAILLARD. Good for you, sir.

Mr. BERG. I am teasing.

[Laughter.]

Mr. DRAILLARD. But, you know, I am a simple equipment manufacturer, so that is way over my head.

The second thing we can definitely do is encourage R&D. Research and development is paramount to continue to modernize our equipment. There is a fleet of airplanes, of corporate airplanes, that are 30 years old in this country. Very soon they are going to fall short of any regulation towards green flying. They are going to come short of any regulation towards the navigation equipment. So we need to encourage R&D and retrofit of airplanes, because this is going to be the structure of the next 30 years of flying in this country.

The third thing we can do is increase the number of tax treaties with other countries, because aviation is big in this country. This country is the birth of aviation, of corporate aviation. However, other countries are developing. If we want to keep our jobs—and I am not talking only of Dassault Falcon Jet here, but there is a number of jobs in Wichita, Kansas, and in Georgia that are related to business aviation—if we, as a country, want to save those jobs and make sure that we expand those industries and expand those areas of the country, we need to have broader, more clear tax treaties with other countries, so we can export airplanes from the United States, and not have them built somewhere else.

Mr. BERG. Thank you. Very good. Mr. DeBoer, on the FIRPTA?

Mr. DEBOER. FIRPTA.

Mr. BERG. FIRPTA.

Mr. DEBOER. FIRPTA. Yes, I know, I——

Mr. BERG. There is a lot of acronyms out here, I am trying to——

Mr. DEBOER. Let's just get rid of it, then we don't have to worry about it.

[Laughter.]

Mr. BERG. That is pretty clear in your testimony.

I guess if you could, give just a brief background on why it is law. What were the political dynamics that caused it to become law? And I know you have some suggestions for changing it, but maybe just address that briefly.

Mr. DEBOER. Sure. You know, I will. Can I just make one comment prior to that?

I found very interesting what you said about attracting the jet manufacturing industry and jobs here. Keep in mind we are talking about real estate. Real estate is here. It is not going anywhere. These are jobs that are in America, and we should be trying to make those assets as healthy and transferable as possible. And I just wanted to make that general point.

FIRPTA itself was put in law in 1980. And I should have said to the chairman I appreciate very much being included in this hearing today, because since that time there really hasn't even been a hearing on FIRPTA. It was repealed, incidentally, in the

1986 tax act by the Senate, but ultimately didn't survive conference.

It was put in place at a time when the world was obviously much, much different. People were a little bit concerned here that foreign entities were coming up into the United States and bidding up the value of farmland. In fact, the evidence showed that foreign investment was less than two percent in farmland at the time. The individual senator who promoted FIRPTA in 1980 was ultimately the individual who led the repeal charge in 1986, when he realized that this was not what was happening in farmland in America.

So, not only was the underlying basis at the time somewhat flawed, but you look ahead to today and you see what is going on globally, as we talk about—and the basis of this hearing is attracting global capital to the United States. Everybody is in competition for capital. And so, the United States today, and investors and real estate owners today, are much more global in where they look for their capital sources to make their properties valuable, and to make them productive parts of the community.

So, a lot has changed. Some of the facts about how it was originally put in place have changed. A number of the tax policy issues that underlie somewhat some of this stuff have changed a lot since then. And certainly the global competition for capital has significantly changed.

Mr. BERG. Thank you. I will yield back.

Chairman TIBERI. Thank you. We are joined today by a gentleman from the full committee who is not a member of this subcommittee, but you are welcome to come any time, the gentleman from New York, Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman. Just on a lighter note, Mr. Draillard, have you or your company ever hired a tax lawyer?

Mr. DRAILLARD. [No response.]

Mr. CROWLEY. I rest my case, your honor. Just teasing.

Thank you, Mr. Chairman, and thank you, Mr. Neal, for holding this important hearing today. The U.S. has the most foreign direct investment of any nation in the world today, and has been the beneficiary of a growing number of companies with headquarters in other countries doing business here in the U.S., as has already been mentioned.

President Obama stated earlier this week that "at a time where we need to use every tool in our toolbox to continue to put Americans back to work and grow the economy here at home, promoting foreign direct investment is an important opportunity to accelerate our economic recovery." I agree.

And the White House issued a report earlier this week that shows our nation's open economy and low barriers to foreign investment have helped to make the U.S. an even more attractive investment for abroad. Stating that, there are still some barriers in the Tax Code that block the free flow of investment here to the United States, and these include, as Mr. DeBoer has mentioned, the FIRPTA tax laws.

I am pleased that the House, in a bipartisan way, passed legislation last year to relax the FIRPTA laws to encourage greater investment in the U.S. commercial real estate market. The bill intro-

duced by Representatives Tiberi, Brady, Berkley, and myself passed the House last year on a vote—a very lopsided vote—of 402 to 11. Unfortunately, though, the Senate did not act upon that bill.

Representative Brady and I plan to reintroduce a similar bill in the coming weeks. Additionally, to more immediately break down other barriers to foreign investment in the U.S. caused by the FIRPTA tax laws, Rep. Brady and I are sending a letter to the Treasury and IRS, seeking an administrative solution to a regulation that is choking investment in the real estate sector at a time when we need more, not less, investment here. And Mr. DeBoer has also expanded upon that.

That brings me to my question for Mr. DeBoer. Kevin Brady and I, as I mentioned, are sending a letter to the Treasury Department and IRS later this week, that we are hoping to get a number of Members on the Ways and Means committee, our colleagues, to sign on to. Our letter seeks the administrative repeal of an IRS rule that adds a new layer of taxation on foreign investors in commercial real estate.

Could you talk about this IRS regulation, and its impact on the real estate market here in the U.S.?

Mr. DEBOER. Sure. The ruling in 2007 reversed the long-standing policy in the tax law, and set, for the first time in the tax law, that a liquidating distribution from a corporation would not be treated as the sale of the stock of the corporation. This is the only part of the tax law where this is so. And, making it even worse, it creates a dichotomy, if you will, in the way that domestic investors and foreign investors are treated on liquidating distribution.

The example might be that you and I engage in a partnership in a domestically controlled REIT, where you have 51 percent, as the domestic owner, I have 49 percent. We own and operate and put money into real estate and make them more productive, and so on and so forth, and we ultimately sell them at a capital gain. We dispose of our entire investment. The liquidating distributions out to the foreign entity would be taxed under FIRPTA. And, as I have described, could be taxed as high as 54 percent.

This is somewhat comical, because, if I wanted to, as a foreign investor, I would simply sell my shares if a market existed to sell the shares, and I wouldn't pay any FIRPTA tax on the sale of the shares. And so, reversing this 2007 notice would immediately bring a substantial number of foreign investors back into the marketplace on these types of properties.

Mr. CROWLEY. I want to ask you my second question to expand upon the benefits, not only to cities like New York, but nationwide, in terms of making these changes. You have already answered that question.

So—but I would make a comment about the issue of what brought this about in 1980. I think there was also a bit of xenophobia when Japan or some Japanese purchased Rockefeller Center. I do note that Rockefeller Center—I checked, I was there last week—it is still in New York City, it never moved to Tokyo. And so I think that also—it is now owned by Tishman Speyer, an American company, as well. So, I think that also brought that about.

We saw the similar events take place during the CFIUS issue when Dubai Ports was in negotiation to run a port here in the States. And I think we brought about a rational solution to that.

But, Ms. McLernon, could you take a moment to address the concerns of some that increased foreign investment in U.S. commercial and real estate could threaten the nation's security and the safeguards in place to prevent that from occurring, in light of what happened in CFIUS reform, and what could—as we discuss FIRPTA, and what is in place to prevent any threat to our national security.

Ms. MCLERNON. Congressman, it is an important question. I should remind those that are in the room that the government already has an interagency committee called the Committee on Foreign Investment in the U.S., known as CFIUS, that reviews all national security implications of foreign acquisitions of U.S. companies. By and large, the vast majority of these M&A deals do not involve national security. And, as I mentioned earlier—and I think I have in my written testimony—98 percent of foreign direct investment is from the private sector.

But the law that governs—the rules that govern CFIUS were strengthened, as you mentioned, in 2007—now includes the Department of Homeland Security, includes the national—the director of national intelligence. And any transaction that involves a foreign government now automatically—or foreign government-owned company—automatically gets kicked into a longer, more thorough, second-stage investigation.

And importantly, even after a deal is completed, if they have not gone through the CFIUS process, the government can actually pull a company back in for review and unwind the deal. So we have very strong safeguards that are in place, thorough, tough, that scrub these deals to ensure that there is no implication for national security.

But again, the vast majority of any sort of M&A transactions that happen in the U.S. cross border do not at all involve national security issues.

Mr. CROWLEY. Thank you, Ms. McLernon, and thank you, Mr. Chairman, for——

Chairman TIBERI. I thank the gentleman from New York. And this concludes the first panel for today's hearing. Please be advised that Members may submit written questions to the witnesses. Those questions, and the witnesses' answers, will be made part of the record.

I would like to thank the witnesses for their informative testimony from the first panel, and for taking the time to appear today. Your input has been very helpful to us, as we continue down the road of moving forward on tax reform. Thank you so much.

We will begin this second hearing and the second panel of this hearing in a few minutes. Thanks for coming.

I would like to thank our second panel of witnesses, and I would like to welcome our three witnesses on the second panel, and I hope you are as good as the first panel. No pressure, by the way.

[Laughter.]

Chairman TIBERI. I will introduce our second panel. Mr. Gary Hufbauer, the Reginald Jones senior fellow at the Peterson Insti-

tute for International Economics; Mr. Robert Stricof, tax partner at Deloitte Tax LLP; and Professor Bret Wells, assistant professor of law at the University of Houston.

Thank you all for joining us today. You will each have five minutes to present your testimony. Your full written testimony will be submitted for the record.

And with that, Mr. Hufbauer, you are recognized for 5 minutes.

STATEMENT OF GARY HUFBAUER, REGINALD JONES SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. HUFBAUER. Thank you very much, Chairman Tiberi, and Members of the Subcommittee. I wish you well on the endeavor to reform the Tax Code.

Let me make five points. First of all, on tax rates. Among advanced OECD countries, the United States has the second worst corporate tax system, from the standpoint of encouraging investment in plant equipment or R&D, or promoting production at home for selling in export markets.

The U.S. corporate tax rate is second highest after Japan. But also, the U.S. average effective corporate tax rate is second highest, and the marginal effective corporate tax rate may well be the highest. I define all these terms in the testimony. But however you look at it, we are high on the tax rate story.

Credible evidence leads me to believe that the output produced by foreign firms operating in the United States would increase by about two percent over a period of time if the corporate tax rate was reduced by one percentage point. So, if we could actually get the corporate tax rate down to 25 percent—a number which has been much discussed in recent months—these foreign firms might enlarge their payrolls from about 5 million—or, actually, 5.7 million—by another million Americans.

I am often asked—and I want to turn now to revenue collection—if U.S. corporate tax rates are so high, why is the revenue collected by the corporate tax system such a modest proportion of gross domestic product. It is about three percent in a good year. I am taking the year 2007, and that compared with the OECD average of nearly 4 percent in that year.

The main reason for the difference is that a very small part of the U.S. tax base of the U.S. GDP belongs to the corporate tax base. It is about 13 percent, compared to the OECD average of about 22 percent. Now, why is the corporate tax base so small? We have a dazzling array of pass-through corporations—pass-through firms, I should say, which skip the corporate tax system. And that doesn't help, clearly.

But also, large firms who have a choice—and that is all large, multinational firms—when other things are equal, and then the choice depends on the tax system, they would rather invest—produce elsewhere, than in the United States. So our tax system does a good job of encouraging the best and brightest firms to invest abroad. But it also does an even better job at discouraging tomorrow's global 1,000 corporations from investing—from putting their headquarters here in the United States.

Let me turn to an important point, and that is the connection between tax rates, statutory tax rates, and revenue collection. The important point is that there is no connection. And I go into this in some detail in a policy brief. But unfortunately, the way the CBO scores these matters, whenever the corporate tax rate is cut, they say that revenue will be lost. That is a complete fallacy. Unfortunately, it colors the ability of the United States to get the corporate tax rate down to a reasonable level.

Let me say just a few words on inward direct investment. My view is that the United States should put more attention on reducing its own rate and making the tax system here favorable and inviting to foreign companies than putting additional effort in cracking down on abuse. I am not saying there is no abuse; I think the tools in the code are adequate, and that is not where the congressional effort should be. Thank you very much.

[The prepared statement of Mr. Hufbauer follows:]

U.S. House of Representatives
Committee on Ways & Means
Subcommittee on Select Revenue Measures

Hearing on Tax Reform and Foreign Investment in the United States

June 23, 2011

Statement by

Gary Clyde Hufbauer
Reginald Jones Senior Fellow
Peterson Institute for International Economics
Washington, DC

Chairman Tiberi and members of the Subcommittee, thank you for inviting me to testify. Reforming the taxation of corporate income ranks among the most important steps Congress can take to promote investment, create jobs, and boost growth. I wish you well on this endeavor. My remarks today are distilled from a recent Policy Brief published by the Peterson Institute for International Economics, titled "Corporate Tax Reform for a New Century" (PB11-2, April 2011). Let me summarize six points from the Policy Brief.

High Tax Rates

Among advanced OECD nations, the United States has the second worst corporate tax system from the standpoint of encouraging investment in P&E or R&D, or promoting production for home or export markets. The US statutory corporate rate (federal and state combined) is second highest, after Japan. The US average effective corporate tax rate (again combined) is also second highest, after Japan. According to one study, the US marginal effective corporate tax is highest in the OECD. When compared to China or up-and-coming emerging regions, such as Eastern Europe and Turkey, the United States is even worse -- tax purgatory. Box 1 briefly describes statutory, average effective, and marginal effective corporate tax rates.

Box 1. Tax Rates Defined

Statutory tax rate. The rate specified in the tax code (federal and/or state) applied to the highest bracket of corporate income. Since states have different rates of corporate income tax, typically an average is calculated for the several states (currently about 4 percent).

Average effective tax rate. This is defined as the amount of tax paid by all corporations (or a subset of corporations) divided by a measure of corporate profits. The World Bank, for example, uses as its denominator "commercial profits", a concept similar but not identical to figures found in corporate financial statements. Consequently, the average effective rate reflects tax credits, special deductions, loss carryforwards, capital gains treatment and the like, all of which serve to reduce the statutory rate.

Marginal effective tax rate. This is the most difficult calculation. The purpose is to estimate that tax rate that will be paid on income from a new investment over the life of that investment, regardless of the tax that might be paid on income from existing investment. Like the average effective tax rate, the marginal effective tax rate is expressed as a percentage of corporate profits. The calculation attempts to reflect circumstances faced by individual firms, such as their loss carryforwards, bonus depreciation, anticipated tax credits, etc.

The damage inflicted by the US system deters both foreign investment in the United States and investment at home by US companies. Credible evidence indicates that cutting the corporate tax rate by 1 percentage point will, over time, increase the output produced by foreign firms operating in the United States by at least 2 percent. Foreign firms employ over 5 million Americans. Cutting the US corporate tax rate by 10 percentage points could potentially increase their employment by 1 million more Americans.

Modest Revenue Collection

I am often asked, "If US corporate tax rates are so high, why are corporate tax payments so modest?" In a good year – for example, 2007 – US corporate tax payments (federal and state combined) were 3.0 percent of US GDP, compared with the OECD average of 3.9 percent. The main reason is that the US corporate tax base is far smaller than the OECD average: 13 percent of GDP compared to 22 percent. The difference is partly explained by the dazzling array of US pass-through firms which skip the corporate tax system. Large firms which have a choice – everything else being equal – would often rather invest and produce elsewhere and ship their goods and services to the US market. Our corporate tax system does a good job at encouraging the best and brightest firms to invest abroad. It does an even better job at discouraging tomorrow's global 1000 corporations from locating their headquarters in the United States.

Rate Cuts and Revenue Collection

For OECD countries, between 1981 and 2007, there was virtually no connection between the combined federal and subfederal corporate tax rate and corporate tax revenue expressed as a percent of GDP. If anything, the relationship was slightly negative. During this period OECD tax rates were progressively slashed from the mid-40% range to the mid-20% range. The policy implication for the United States is short and powerful: the US statutory rate could be safely cut from 35 percent to 25 percent with no appreciable impact on corporate tax revenue.

Moreover, serious econometric analysis (PB11-2) shows that, if there is a loss of corporate revenue from cutting the corporate tax rate, that will be offset by higher personal income and payroll taxes, as investment surges, people go back to work, and wages rise. After reviewing various studies, I conclude that cutting the statutory tax rate by 10 percentage points would

increase the US capital stock by at least 5 percent, and put at least 600,000 people back at work in US firms – in addition to new American employees in foreign firms. Existing employees would enjoy wage gains of almost 2 percent because the additional capital stock would boost productivity.

Inward Foreign Direct Investment

Inward foreign direct investment brings jobs and technology to the United States. In their path-breaking study, *Foreign Direct Investment in the United States* (3rd edition, 1995), Graham and Krugman showed that foreign firms on average spent more money on R&D and paid better wages than their domestic counterparts. Nothing I have read since contradicts a generally favorable impression. In fact, the recent CEA publication, *U.S. Inbound Foreign Direct Investment* (June 2011) reinforces this impression. While the United States has attracted a huge stock of inward foreign direct investment ($3.4 trillion) by firms that employ 5.7 million Americans, more would be better. Other countries are catching up, but the United States is still the largest destination for inward foreign investment.

How do taxes fit in the equation? Obviously the United States holds many attractions for foreign firms, but a competitive tax system is not among them. It is not surprising that foreign firms attempt to repatriate as much income as possible to their parent firms abroad in the form of interest and royalties, which count as deductions from corporate taxable income and are taxed at low or zero rates under US double-tax treaties. Of course the IRS seeks to deter excessive interest payments resulting from unduly high debt leverage (characterized as "earnings stripping") and excessive royalty payments for intellectual property rights. But in my view, this is not the time to "crack down" with new legislation designed to give the IRS even stronger tools. By and large, inward foreign investment is great for the US economy, and we should want more of it. To lessen tax abuse, the first step the Congress should take is to sharply lower the US corporate tax rate so that foreign firms doing business here have less incentive to remit income to their parent firms abroad in the form of interest and royalty payments.

Worldwide Tax Conceits

The United States is the charter member of a shrinking club that espouses worldwide taxation of corporate income. Among countries tracked by the OECD, only 6 others practice worldwide taxation, and most of them impose substantially lower corporate tax rates than the United States. All the rest, some 26 countries, have adopted territorial tax systems. Nevertheless, US tax authorities – the Treasury and the JCT -- firmly adhere to the outmoded notion that worldwide taxation is somehow the norm. This notion in turn fosters two damaging conceits.

The first conceit is calculating tax expenditures -- the difference between an imagined "ideal" tax system and the actual US tax system – on the supposition that worldwide taxation is the "ideal" system. In reality, worldwide taxation is not the ideal. In fact, it is not even the norm. Yet this conceit leads the Treasury Department to publish a forecast of $213 billion as the tax expenditure over the years 2012 to 2016 associated with deferred US taxation of foreign income.

The notion that worldwide taxation is the ideal, and should become the norm, leads to a second and even worse conceit. The conceit is thinking that the central answers to transfer price abuse, earnings stripping, and parking income abroad will be found in curtailing deferral, curbing the foreign tax credit, and enacting higher penalties. Such misguided answers are offered in hopes of protecting the high US corporate tax rate from its own destructive consequences -- in a world where other countries are sensibly slashing their own corporate tax rates. The outmoded tax strategy brings to mind medieval attempts at protecting the castle by digging a wider moat. Water moats didn't protect castles in the Middle Ages and tax moats won't protect the American economy in the 21st century.

***

More detail will be found in the referenced Policy Brief. Thank you for the opportunity to testify.

Chairman TIBERI. Thank you.

Mr. Stricof, you are recognized for five minutes.

STATEMENT OF ROBERT STRICOF, TAX PARTNER, DELOITTE TAX LLP, NEW YORK, NEW YORK

Mr. STRICOF. Thank you. 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 30 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 is largely focused on serving industrial companies in 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. These impediments include: the earnings-stripping provisions; potential U.S. tax law changes regarding the determination of corporate residency; U.S. income tax treaty override proposals; FIRPTA; and, to add another acronym, FBAR reporting.

In respect of earnings stripping, as has been said in earlier testimony, I would like to point out that there is no clear-cut data that demonstrates that there is a systematic problem with earnings stripping. The Treasury Department conducted a study on this issue, and concluded that there wasn't clear evidence of earnings stripping by foreign-based multinational companies making direct investments into the United States.

In order to further this study and gather more data, Form 8926 was issued. This form is defective in many ways. For example, it is unclear whether a taxpayer should rely on the proposed regulations issued in 1991 under section 163(j) when answering the various questions on the form.

Additionally, there is no guidance as to whether the form should be filed on an expanded affiliated group basis or on a stand-alone affiliated group basis. As a result, similarly situated taxpayers are likely filling out the form very differently from one another. This means that the data that Treasury gathers from form 8926 is likely unreliable, and it is doubtful that an analysis of the information provided on the form will accurately provide reasonable conclusions as to whether earnings stripping is taking place.

Moving on to corporate residency, it is important to note that determining where a corporation is a resident is essential to identifying where that corporation will be taxed. The proposed managed and controlled test would determine corporate residency based on the jurisdiction where 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 based. This will raise uncertainty regarding which operations of a multinational would be taxed in the United States on such entities' global income.

Any uncertainty in this area may cause foreign multinational companies to shift U.S.-based management teams outside the U.S., which would cause the loss of high-paying jobs in the United States. The management and control provision will be extremely difficult to administer, and is likely to lead to inconsistent administration that will clog the competent authority process with our treaty partners. Given the administrative, technical, and policy concerns surrounding the management and control proposal, I would urge the retention of the current law rules on determining corporate residency.

In respect to the income tax treaty override proposals, the proposals, as drafted, would override almost all of our income tax treaties, in that the active trader business test for qualifying for treaty benefits that is included in almost all of our treaties would be significantly reduced in scope. The active trade or business test is perhaps the most fact-intensive test for determining whether an entity qualifies for treaty benefits.

The test typically requires an entity to show that the business in the home country is substantial in relation to the U.S. business, and the income receiving treaty benefits is related to that business. Arguably, this is the most rigorous test in the limitation on benefits section of our treaties, and is not one that should be overwritten.

When legislation was originally proposed, the treaties with Iceland, Poland, and Hungary were perceived to be abusive and abused by non-treaty ultimate parents. Since that time a new treaty with Iceland has entered into force, a new Hungarian treaty has been signed, and the Treasury Department has indicated that negotiations on a new treaty with Poland have been concluded. Therefore, what may have been one of the main reasons for the proposal is no longer an issue.

My paper also contains comments on FIRPTA and the so-called FBAR provisions. In respect to FIRPTA, my main comments relate to the administrative burden the current rule has, as any U.S. corporation is presumed to be a U.S. real property holding company. Taxpayers, particularly in controlled group transactions, have often missed filings, as they are not thinking about FIRPTA when they know that their subsidiary in the United States has very few assets that are invested in U.S. real property. Having this presumption has required many taxpayers to request relief for missing filings related to transactions that are not within the scope of the provisions. A change to this presumption would ease this administrative burden.

In the context of the FBAR provisions, there are unintended consequences that may result from a foreign parent using a foreign bank account where a U.S. person has signatory authority to make expenditures on behalf of the corporation, but has no personal financial interest in the account. These persons are required to report their signature authority over a corporate bank account in which they have no personal interest. These filing requirements should be reviewed in order that they would be more targeted at the persons that have a direct financial interest in these accounts.

Thank you very much 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.

[The prepared statement of Mr. Stricof follows:]

TESTIMONY OF ROBERT STRICOF
TAX PARTNER, DELOITTE TAX LLP
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

---

[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.

---

[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.

---

[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.

---

[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.

Chairman TIBERI. Thank you.

Mr. Wells, you are recognized for five minutes.

STATEMENT OF BRET WELLS, ASSISTANT PROFESSOR OF LAW, UNIVERSITY OF HOUSTON LAW CENTER, HOUSTON, TEXAS

Mr. WELLS. Thank you, Chairman Tiberi, Ranking Member Neal, and distinguished members. In this testimony I would like to address the following items: first, the issue of tax competitiveness; and second, the issue of tax base erosion.

Let me start by saying that I believe that tax competitiveness is a serious issue. When the U.S. activities of U.S. domestic companies are treated less favorably than the U.S. activities of inbound competitors, a serious structural problem is created that deserves careful attention by Congress. Tax rules that treat U.S. activities of different economic participants differently will cause the tax disfavored economic participant to seek to become a foreign-owned company. Or else they risk getting forcefully acquired.

The capital markets demand that this occur, and the recent corporate inversion phenomenon is a wake-up call about the serious implications of an unequal playing field. Foreign-owned multi-

nationals have a competitive advantage in the United States exactly because they are foreign owned. Certain U.S. multinationals with inbound investment activity share this advantage. But the tax advantage afforded to inbound investors arises because of their ability to erode the U.S. tax base through base erosion payments.

Base erosion payments arise from related party transactions such as intercompany charges for interest, as Mr. Spitzer so eloquently talked about earlier, rents, royalties, as Mr. Spitzer pointed out earlier, service fees, and from intercompany purchase and sales of tangible goods between a U.S. affiliate and a foreign affiliate. Through effective tax planning, these base erosion payments can create homeless income.

The income is homeless in the sense that it is not subject to tax in the United States, where it originated, and where the profits were derived, nor is it taxed in the offshore country where it is received. The ability to create homeless income affords inbound taxpayers a significant tax advantage and unlevel playing field.

How did it come to be that base erosion payments could be such a powerful tax planning advantage? To answer this question, it is helpful to consider the historical context of the United States when it formulated its international tax policy.

In the early years, U.S. multinationals were the dominant source of FDI around the world. And so, outbound investment far exceeded U.S. inbound investment. In this setting, the United States Government wanted the residual profits to escape source country taxation so that these profits could be taxed by the country that supplied FDI, meaning the United States in a majority of cases. Residency taxation took preference over source country rights to taxation.

And so, to further this policy, the U.S., through our treaties, sought to require source countries to eliminate withholding on interest, rents, royalties, in deference to the home country's sole right to tax these profits. The United States relinquished its own withholding rights as a reciprocal measure. But again, the trade flows were tilted in favor of the United States.

Today, the trade flows are reversed, with the United States finding itself in the posture of a significant net capital importer. Further, not surprisingly, taxpayers have reacted to these generous inbound tax rules with full advantage. Today, inbound investors can use offshore tax favored subsidiaries to transact with their U.S. affiliate, move profits within their affiliated companies without it leaving the economic group, and earn thier income in a tax-favored way.

Homeless income is a mistake. U.S. international tax policy was formed with the desire to prevent international double-taxation. This, gentlemen, is a worthy goal. But the desire to prevent double taxation was never intended to have the consequence of creating homeless income out of U.S. business profits.

Income earned in the United States economy should bear one level of tax. And the assumption should now be that it won't be taxed anywhere in the world, if not here. And not subjecting profits of inbound taxpayers to at least one level of tax creates an unlevel playing field with domestic companies.

Homeless income is a mistake that costs the United States Treasury significant revenue. This mistake places inbound participants in a better economic position versus U.S. companies that do not have base erosion opportunities. If left unfixed, this state of affairs will cause U.S. companies to become prime takeover candidates, or encourage them to self-help themselves into inverted companies.

Again, the corporate inversion phenomenon is merely telling us what we already know. The basic issue is the following: inbound companies can utilize multiple avenues to strip earnings from the U.S. tax base with the benefit of creating homeless income out of a significant portion of their U.S. profits. We need a policy response that protects the U.S. tax base against base erosion, not just because we need more revenue, but because we need equal treatment between U.S. domestic companies and cross-border inbound participants.

In my written testimony I provided a proposal that attempts to prevent homeless income. But let me conclude by saying that it is my belief that Congress cannot allow inbound taxpayers to have significant opportunities that do not exist for U.S. domestic corporations. Everyone should pay a similar level of tax for similar economic activity in the United States. The ability of inbound taxpayers to create homeless income out of U.S. profits attacks the very core of the U.S. tax system, and must be addressed.

Thank you so much for the opportunity to testify.

[The prepared statement of Mr. Wells follows:]

TESTIMONY OF PROF. BRET WELLS
HEARING ON TAX REFORM AND INVESTMENT IN THE UNITED STATES

U.S. House Committee on Ways and Means
Subcommittee on Select Revenue Measures

June 23, 2011

Chairman Tiberi, Ranking Member Neal, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Bret Wells, and I am an Assistant Professor of Law at the University of Houston Law Center. I hold a JD (with honors) from the University of Texas School of Law. I have over twenty years of experience in the tax area, much of that time working in industry. I have previously served as Vice President—Treasurer and Chief Tax Officer for BJ Services Company, which was an S&P 500 Index company until last year. In my prior industry position and in my current position in academia, I have had the opportunity to consider why expatriated and foreign-owned companies have a significant competitive advantage in the US marketplace over US-owned companies.[1]

In this testimony, I would like to address the following items:

1. The issue of tax competitiveness.
2. The issue of tax base erosion.
3. An approach to achieve both tax competitiveness and prevent tax base erosion.

1. Competitiveness.

Let me start out by saying that I believe that tax competitiveness is a serious issue. When the US activities of US domestic companies are treated less favorably than the US activities of inbound competitors, a serious structural problem is created that deserves careful attention by Congress. Tax rules that treat the US activities of different economic participants differently will cause the tax disfavored economic participant to seek to become a tax-favored economic participant . . . or else they risk getting forcefully acquired. The capital markets demand that this occur. The recent corporate inversion phenomenon is a wake-up call about the serious implications of an unequal playing field.[2] Foreign-owned multinationals have a competitive advantage in the United States exactly because they are foreign-owned. Certain US multinationals with inbound investment activities share this advantage to some extent. The tax advantage afforded to inbound

[1] The views expressed here are solely my own views and do not necessarily reflect the views of University of Houston Law Center or of any prior employer.

[2] For a more extensive discussion of these advantages and how corporate inversions highlight these advantages, please see Wells, *"What Corporate Inversions Teach Us About International Tax Reform,"* 127 Tax Notes 1345 (June 23, 2010).

investors arises because of their ability to erode the US tax base through base erosion payments. Base erosion payments arise from related party transactions such as intercompany charges for interest, rents, royalties, services fees, and from intercompany purchases and sales of tangible goods between a US affiliate and an offshore foreign affiliate.[3]

Through effective tax planning, these base erosion payments can create "Homeless Income." The income from these base erosion payments is "homeless" in the sense that it is not subject to taxation in the United States where it originated nor is it taxed in the offshore country where it is received. Others have referred to this type of income as "Stateless Income," but regardless of nomenclature[4] the result is that inbound economic participants can create zero taxed income for a significant portion of their income arising from their US business activities. The ability to create Homeless Income, therefore, affords inbound taxpayers a significant tax advantage and creates an unlevel playing field.

Congress can respond to an unlevel playing field in one of three ways. First, Congress could choose to reduce all taxes for all business activity, thus making everyone tax-favored. Given the current fiscal budget crisis, I assume that this option is not feasible or prudent for the country. Second, Congress could choose to ignore the problem by saying that we should simply provide a tax advantage to inbound investors in order to create an extra incentive for those investors to participate in the US economy. Over time, this choice will cause tax-disfavored companies to transform themselves into tax-favored companies, and so in reality this second choice is much like the first choice except that the marketplace is the mechanism for converting tax-disfavored economic participants into tax-favored economic participants. The third alternative is for Congress to collect corporate taxes at a politically agreed-upon tax rate but to do so in a manner that attempts to tax the US activities of all corporations in a comparable manner, whether they are inbound investors or not. For the balance of my testimony, I will assume that Congress will want to proceed with this third approach.

---

[3] Staff of the Joint Committee on Taxation, *"Present Law and Background Related to Possible Income Shifting and Transfer Pricing,"* JCX-37-10 (July 20, 2010). Foreign affiliates owned by US multinationals generally cannot engage in base erosion strategies with a US affiliate that are premised on intercompany interest, rent, or royalty charges due to the Subpart F rules. *See* §952(a)(2); §952(b) (excludes US source income from subpart F income only if it is effectively connected income); §954(c)(1)(A); §956(a) (treats loans to US affiliates from controlled foreign corporations as investments in US property with the consequence that these investments trigger a subpart F inclusion to the extent of the unrepatriated foreign earnings and profits of the controlled foreign corporation). But, base erosion arising from intercompany service charges and from intercompany purchases and sales with a foreign affiliate may not be subject to current US taxation under the US subpart F rules and thus are available means to achieve base erosion. *See* Treas. Reg. §1.954-4(a)(2) (managerial services can be charged to the US affiliate without creating a subpart F inclusion by reason of the related party services income provisions of §954 if those services are performed within the country of the service provider's incorporation); Treas. Reg. §1.954-3(a)(4) (manufacturing exception); Treas. Reg. §1.954-3(a)(1)(ii) (exempt commodity exception).

[4] Edward D. Kleinbard, "Lessons of Stateless Income," USC Legal Studies Paper No. 11-7 (abstract available as of April 19, 2011, at http://ssrn.com/abstract=1791783).

2. Tax Base Erosion

How did it come to be that base erosion payments could be such a powerful tax advantage? To answer this question, it is helpful to consider the historical context for the foundational premises of the extant US international tax policy. In the early years, US multinationals were the dominate source of FDI around the world, and so US outbound investment far exceeded US inbound investment. In this economic setting, the United States government wanted to maximize the amount of residual profits that could escape source country taxation so that these residual profits could be taxed by the country that supplied the FDI, meaning the United States in the majority of cases. Residency taxation took preference over source country rights to tax. Furthermore, US transfer pricing policies maximized residual profits that could be reported by the country that held the intellectual property and was the source of capital and equipment, and so to further this policy the US tax treaties sought to require source countries to eliminate withholding taxes on interest, rents, and royalties in deference to the home country's sole right to assert taxing jurisdiction over these items of profit. The United States also relinquished its own withholding tax rights as a reciprocal measure, but again the trade flows were tilted in favor of the United States. In hearings before the House Ways and Means Committee in 1930, Professor Thomas Sewell Adams testified that the reduction in US withholding taxes was of no significant concern because the United States treasury would be the net beneficiary if both countries reduced sourced based withholding taxes since the United States was a net capital exporter.[5]

Thus, although the US source country tax rights have been purposely subordinated, this concession was made in the context of the United States government expecting that a greater amount of residual profits would flow into the United States treasury because of the reciprocal subordination of the source country tax rights of other countries. Today, the trade flows are reversed with the United States finding itself in the posture of a significant net capital importer. Furthermore, not surprisingly, taxpayers have reacted to these generous inbound tax rules and have taken full advantage of them. Today, inbound investors can use an offshore tax-favored subsidiary to transact with their US affiliate so that US origin profits can be earned in a country that chooses not to tax offshore income. This committee received testimony last month about the fact that many countries have adopted territorial tax regimes. Given that this is the case, the United States' continued willingness to allow base erosion payments to escape any US source country taxation allows large amounts of US origin profits to become Homeless Income due to the fact that many of our trading partners now disclaim taxation of extraterritorial income.

Homeless income is a mistake. US international tax policy was formed with the desire to prevent international double taxation. This is a worthy objective. But, the desire to prevent double taxation was never intended to have the consequence of creating Homeless Income out of

[5] *See* Statement of Dr. Thomas S. Adams, Hearings on H.R. 10165: A Bill to Reduce International Double Taxation before the House Ways and Means Committee, 71 Cong. 2d. Sess. at 47-48 (March 1, 1930), *reprinted at* Staff of the Joint Committee on Taxation, Legislative History of United States Tax Conventions (Vol. 1) at 33-34 (1962).

US origin profits. In 1923, a group of economic experts issued a report to the League of Nations indicating their belief that over time that a significant majority of countries would eventually choose to tax their companies on a worldwide basis,[6] and so relinquishing source country taxation would serve only to shift the incidence of taxation but would not be expected to change the amount. But, the world has evolved in exactly the opposite direction with many of the United States trading partners adopting territorial tax regimes. Income earned in the United States economy should bear one level of tax, and the assumption should now be that it won't be taxed anywhere else.

Homeless Income is a mistake that costs the United States treasury significant tax revenue. This mistake places inbound economic participants in a better economic position versus US companies that do not have these same base erosion opportunities. If left unfixed, this state of affairs will cause US companies to become prime take-over candidates or encourage them to engage in self-help efforts to transform themselves into the tax-favored economic participant. Again, the corporate inversion phenomenon is merely telling us what we already know.

Congress has reacted to this inbound advantage in the past by enacting targeted measures such as Section 163(j) and Section 897, but those remedies do not represent a comprehensive approach to protecting the US tax base from the full range of potential tax base erosion payments that exist. The basic issue is the following: inbound companies can utilize multiple avenues for stripping earnings from the United States tax base with the benefit of creating Homeless Income out of a significant portion of their US origin profits. Efforts to attack this problem through the Subpart F regime may close this base erosion loophole for the inbound activities of US multinationals, but these Subpart F reforms do nothing to change the fundamental loophole for the inbound activities of foreign-owned multinationals since these multinationals are generally not subject to the US subpart F regime. And, what is worse, attacking the Homeless Income problem via subpart F reforms are anti-competitive because they create a greater disparity between US multinationals versus foreign-owned multinationals. Thus, we need a policy response that protects the US tax base against base erosion payments regardless of whether the inbound base erosion strategies are conducted by a US multinational or by a foreign-owned multinational.

3. Base Protecting Surtax[7]

In my view, the United States should consider imposing a gross "base protecting surtax" on any base erosion payment made by a US payor to a foreign affiliate. The existing US transfer pricing rules have done a fairly good job at ensuring that the routine operating profits of US affiliates are

[6] Report on Double Taxation to the Financial Committee of the League of Nations," League of Nations Doc. E.F.S. 73 F 19 at 51 (April 5, 1923).
[7] This proposal is more fully developed in an unpublished manuscript entitled Bret Wells & Cym Lowell, *International Tax Reform: Source and Collection are the Linchpins"* (unpublished manuscript).

reported in the United States, but those rules have not been successful at ensuring that the residual profits created by activities in the United States are taxed in the United States. To correct this situation, the presumption should be that base erosion payments strip residual profits from the United States and a net basis tax of thirty-five percent (35%) should be owed on these residual profits until proven otherwise. The surtax rate would need to be determined, but let's assume for this discussion that a ten percent (10%) surtax on the gross amount of a base erosion payment represents a reasonable upfront estimate of a net thirty-five percent (35%) tax after considering allocable expenses.[8]

If the inbound multinational thinks that the 10% surtax is excessive versus the tax that would have existed had the residual income been subjected to a 35% net basis tax after considering all appropriate deductions, then it can disclose its foreign company's books and records so that the IRS can correctly determine the actual residual net profits that deserve to be taxed in the United States. If the taxpayer proves their case, then a refund of the excess portion of the surtax could be given.[9]

When assessing the appropriate amount of US tax that should apply on residual profits, the United States should use either a formulary apportionment or a profit-split methodology to ensure that the United States is able to tax its fair share of the residual profits of the combined global income. Furthermore, in applying these transfer pricing methodologies, a functional analysis should be performed to determine which country is entitled to tax the residual income, and until proven otherwise the United States should start with the premise that the residual profits are Homeless Income and should be taxed in the United States since they arose from the United States. As a general matter, countries tax the functions that actually occur in their own country, so the United States should not allow base erosion payments to escape US taxing jurisdiction unless it is satisfied that some portion of the residual profits are rightly attributable to the functions performed in the other country. Because this proposal uses existing transfer pricing concepts of profit split or formulary apportionment to calculate the final tax, it satisfies the guideposts of Article VII of the US tax treaties that require the United States to collect tax only on the profits that are attributable to the United States.[10]

Thus, the presumption is changed. This proposal prevents Homeless Income before it is created because it collects an upfront surtax on the gross amount of the base erosion payment. If the

[8] For the balance of this testimony, I focus on how the base protecting surtax would particularly apply to inbound taxpayers given that inbound issues are the focus of today's hearing, but it should be noted that this proposal applies to all base erosion payments and not just to base erosion payments of inbound taxpayers. As such, this proposal would also serve to address situations where US multinationals might attempt to earn excess residual profits in an offshore foreign affiliate through base erosion payments made to that foreign affiliate.

[9] The IRS could also be given authority to reduce the base protecting surtax to a lower amount if its application would be particularly excessive by providing a Base Clearance Certificate on the condition that the inbound company provide its foreign books and records and participate in a review process.

[10] *See, e.g.*, Article VII(2) of the US Model Income Tax Convention (November 15, 2006).

foreign affiliate of a foreign-owned multinational does not wish to disclose their offshore books and records, then at least a 10% gross surtax is collected and retained. But, for many inbound multinationals, this proposal would create an incentive to be transparent and to work with the IRS to determine the correct amount of tax that is due on the residual net profits arising from their US inbound activities. Because current law allows base erosion payments to become Homeless Income, the IRS is left in the unenviable position of trying to defend the US tax base against a zero tax result through costly and expensive audits where they may have difficulty obtaining foreign books and records. An upfront surtax changes the incentives.

The intent of this recommendation is to ensure that residual profits do not get allocated away from the US taxing jurisdiction unless a true functional analysis is performed that considers the overall profits of the global company using a combined transfer pricing methodology. Protecting the US tax base against tax base erosion serves the goal of addressing the Homeless Income problem and serves to further the goal of not allowing inbound companies to create a competitive advantage. If inbound economic participants did not have a tax advantage over their domestic competitors, then the tax advantage of locating jobs overseas in order to supply products to the US marketplace would be reduced. To the extent that this proposal eliminates a tax handicap and equalizes the playing field for all economic participants, this proposal should serve to ensure that no US economic participant receives an unfair tax advantage and thus tax competitiveness concerns are addressed. Finally, to the extent that the United States can better collect taxes on inbound activities so that Homeless Income does not get created from US base erosion payments, such an effort would provide a source of much needed tax revenue by closing an unnecessary tax loophole.

Thank you again for the opportunity to testify.

6

Chairman TIBERI. Thank the three of you for your great testimony. I have got a question for all three of you, and I will start to my left here.

You have all talked about—in either your written testimony or your verbal testimony—that we have the—we have a comparatively high U.S. corporate tax rate, compared to our competitors around the world. And there are incentives that multinational companies doing business in the United States have to transfer their income overseas.

What do you suggest we can do, through tax policy, to change that incentive?

Mr. HUFBAUER. Thank you, Chairman Tiberi. Here I think there is a sharp difference between Professor Wells and myself. We used to have a worldwide tax system as our concept of the norm—and I wrote about that in my testimony, I didn't have time to discuss it. The worldwide tax system has long not been the norm. It is now only followed by about six countries, none of which have the high tax rates which the U.S. imposes.

We are out of step, it isn't that the world is out of step. And we cannot go back to 1960, when the United States dominated the world, not only militarily but economically. We are now in a very competitive situation, as you well know.

So, my answer to your question is we have to get our rates down to where other countries are, which is if we are going just talk about the OECD countries we need to cut at least 10 percentage points, and I would say 15 percentage points, off the statutory corporate rate. If we want to talk about China—and many people do—it has to go further. We are way out of step. That is the biggest single thing. And I think that is where the attention should be focused, not on trying to, as I put it in my testimony, build a moat around a U.S. tax system which is out of step.

And it is not just out of step with China, it is out of step with Canada. Canada has a far more competitive tax system than we do.

I am just focusing on the rates, but I could extend that to many other dimensions, particularly research and development, a favorite subject of mine, or expensing of equipment, or whatever. I mean we are just a country which does not use its tax system to encourage investment, either in physical capital or intellectual capital. Thank you.

Chairman TIBERI. Thank you.

Mr. STRICOF. It is very difficult for me to address policy issues, as a tax technician. I am not a tax lawyer; I am just a tax accountant. But let me give a little bit of my view on this.

There is a big competition for capital in the world. People have choices as to where to deploy their capital, where to earn their profits. If you have a choice of employing your capital in a place where you can pay a 20 percent tax rate, or a place where the combined federal and state rate is easily 40 percent, where would you want to earn your profits? It is a very simple, methodical type of analysis, and a number of companies do that type of analysis when deciding where they can put their businesses.

Unlike Nestle, which has to put a lot of its business where the consumers are, a lot of other types of activities can be put anywhere in the world. The point made for Falcon Jets. They could be manufactured anywhere, and they can fly here to be purchased by U.S. consumers. So I think you have to look to see what is going to encourage people to invest here.

I would also like to address a comment that was given to the earlier panel, which was, "If there was a choice between lowering the corporate tax rate and getting rid of the R&D credit, what would you do?" Here, in this environment, I think you have to look and see what other countries, for example the UK, Netherlands, and many others have done. What they have done is they have lowered their corporate tax rate, and also provided incentives for R&D.

They have their patent box regimes and other regimes that encourage specific activities, as well as general activities.

Chairman TIBERI. Thank you.

Mr. WELLS. It is a very important question, Chairman. Let me say that my comment earlier was not to say that I pine for the days when residency taxation were better. I just want us to understand why we thought it was good to allow earnings stripping in the past, when the U.S. was the dominant source of capital, and would be the beneficiary.

What we find today is our tax rates are high. I agree with Mr. Hufbauer on that point.

But focus on the testimony you heard earlier. Nestle had an effective tax rate less than 10 percent worldwide in their financial statements. How can it be that a consumer food company in the domestic economies of the OECD can get less than half the percent of the tax rate that this committee is discussing?

It is because—they have told you already—their ability to strip earnings out of the U.S. economy and other countries allows them to achieve an effective tax rate that is significantly below the rates we are talking about. I don't disagree with Mr. Hufbauer saying that lower rates would be a better system. But it is not going to be low enough to cause anyone not to want to earnings strip.

Now, Mr. Hufbauer said China has a more favorable regime. But let's remember they have withholding taxes on interest and royalties, and have refused to give zero tax treatment to those types of payments cross-border. So we can learn from China. There is no question that when someone earns profits from the U.S. activity, it should not escape total taxation.

And the other point I would make is this, that if we allow inbound investors to have a significant competitive advantage versus their U.S. competitors, the corporate inversion phenomenon is telling us the result. We must treat U.S. companies the same. And if they are going to pay a full U.S. tax on U.S. business activity, then we must have a system that causes inbound taxpayers not to pay more than their fair rate, but at the same time to pay at least the same rate. If we don't, we are rewarding winners and losers unfairly. And the ability to have interest stripping and royalties stripping is a benefit that an inbound company has, that Nestle has, that others have, that U.S. companies that are U.S.-based do not have.

Thank you for the opportunity.

Chairman TIBERI. Thank you. Mr. Wells, I want to follow up. Thank you for your thoughts, too.

You wrote an article about a year ago in Tax Notes—and I want to quote from it—regarding our corporate tax rate and our worldwide system. "Disadvantaged ownership of capital by U.S.-based multinationals creates an incentive to shift that ownership away from U.S.-based companies to foreign-owned competitors, and the recent empirical studies suggest that this possesses a significant threat to U.S. domestic job creation."

And your article goes on to state that the U.S. should move toward a territorial system that exempts active foreign income. Do you still believe that, and can you expand on that?

Mr. WELLS. Yes. What I was saying in the article is that the ability for U.S. companies, or the inability of U.S. companies to be able to earn income in the same low-taxed environment that foreign-owned companies have is a competitive disadvantage. And we should expect that foreign-based companies would have an opportunity to take those companies over to the extent there are synergies for them to acquire them.

A territorial regime versus our existing regime is—there are pros and cons to either approach, okay? And if you had a territorial regime as the premise of what this committee wanted to propose, it would be incumbent on this committee to make sure that there were base-protecting measures that would protect the U.S. tax base from being able to be eroded by all taxpayers. In a territorial regime, the opportunities to erode the U.S. tax base would exist for every participant. So, it would be a challenge that this committee would be required to take, because everyone would be in the same position.

But the point I think the committee should consider is whether it's a territorial regime or a worldwide regime, certainly how we tax inbound activity should try to achieve comparable results for each economic participant, whether they are a U.S. company or a foreign company. How you treat outbound activities and the disparity between U.S. multinationals and foreign multinationals in third countries is a harder question.

But certainly taxing the inbound activities, we should attempt to have a horizontal equity between each of those two companies.

Chairman TIBERI. Mr. Stricof, can you comment on that issue?

Mr. STRICOF. Most certainly. Foreign-based companies, the ones that invest in the United States, are largely in developed countries. As was pointed out by Nancy McLernon in the earlier panel, China represents less than one percent of all foreign investment into the United States. So, where is this money coming from?

The money is coming from Germany, from France, from the UK, and others. And each of these countries has effectively decided that their equivalent of subpart F—because most of them have that—do not really need to cover the type of income that is being talked about as being earnings-stripped. And, instead, must view that money as being more important to come into their local country however, and then be redeployed in their local economies.

And what is that doing? I don't see where the UK is suffering nearly as much as the U.S. or France or Germany or any of a number of these other countries that have these significant rules. I see the money coming back to those home countries, and being redeployed in their businesses.

When it comes to base erosion, what was commented upon was two or three different factors of base erosion. There are management service charges, there are rent and royalties, and then there is interest expense. When it comes to management charges, I personally do not see management charges coming into the U.S. to the same degree as I see management charges going out from the U.S. by U.S.-based multinationals.

When it comes to rent and royalties, IP is usually centrally located in a country where the company is based. It is appropriate to charge a rent or royalty for the use of IP, just like U.S. multi-

nationals, if the IP is owned by the U.S. company, charges out for the use of IP. While payments for IP are base-eroding, I imagine in concept, they are really not base-eroding with the same negative connotation that has been given.

And, as I have already commented, in respect of interest expense it is difficult to say whether U.S. companies are eroding their tax base any more than anybody else. There is just no empirical evidence of that. Thank you.

Chairman TIBERI. And finally, Mr. Hufbauer.

Mr. HUFBAUER. Thank you. I guess the first point that would be made is when it comes to base erosion—and I have written about this at length—my big concern is the erosion of the personal income tax. And quite a bit of legislation has been passed by Congress. Some of it maybe goes too far, but it is in the right direction to not have U.S. citizens or residents avoid the U.S. tax system by putting their assets abroad. That, to me, is the big concern.

In terms of base erosion by corporations or business firms, they—I think the only area of important concern is interest payments, for the reasons that Mr. Stricof said. Royalty—I mean our interest, our national interest in royalty, is exactly to keep the rates very low, because our royalty income from abroad of all kinds—trademark, copyright, intellectual property patents, or whatever—is huge coming in, and rather small going out. So, if you have a system where a goose—you know, sauce for the goose is sauce for the gander—we want to get those rates low.

In addition, I would commend to the congress to think about the kind of patent box system that Netherlands and a few other countries have introduced, not only to keep the rates low, but to tax that kind of income at a very highly preferential rate here in the United States to encourage R&D. That, to me, is a meaningful R&D encouragement which we should have, and we don't have.

But turning briefly to interest income, this is a very—you might say it is homeless on a worldwide basis. The tax rates are very low, and I have written about that extensively. They are low here in the United States, they are low abroad. It is a low-tax form of income. It has kind of distorted debt equity ratios globally. It has contributed to our financial crisis. I think it is a problem, and I think, if you are going to worry about erosion, it really should focus on the interest side of the whole picture.

Finally, let me say that I—Professor Wells and I are in total agreement, I believe from the excerpt he read, on the necessity of having a territorial system with a view to U.S. outward investment. So we are in very close alignment there. Our current system is quite discouraging to U.S. companies, by comparison with companies based in almost any other country.

Chairman TIBERI. Thank you, all three of you. I will yield to the ranking member, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Let's go back over a couple points that have been made here.

Professor Wells, you are pretty blunt in your testimony that foreign owned multinationals have a competitive advantage in the United States because they are foreign owned. You go on to say that that tax advantage afforded to inbound investors arises be-

cause of their ability to erode the U.S. tax base through base erosion payments.

What about a specific example, and how prevalent is this?

Mr. WELLS. I can give you several specific examples. One was when I was vice president, treasurer, and chief tax officer of an S&P 500 company. I saw half of my peer group invert. And I read the public statements. Why did they invert? Why did they want to become foreign multinationals, when it was a paper transaction? And what they said was is that they needed to get at the same tax rate as their other competitors. That was the reason they did it. That was their public statement.

So the first thing I would say, Mr. Neal, is that—the inverted companies are telling us why they did it.

The second thing, in the article that the chairman referred to I said, "Well, let's test whether what they said was right." So I took the five-year average tax rate for the inverted companies in my peer group, and I compared it to Schlumberger, the Behemoth in the oil field services sector. And I said, "What do their tax rates look like?" And they were within half a percent. Imagine that. They got to within a half-a-percent. Now, their tax rate dropped from 37 percent, the average of these companies pre-inversion, down to 20 percent post-inversion. But the 20 percent post-inversion rate was on par with their other foreign competitors. So, I would say that subsequent experience helps us understand.

But then there were other acquisitions that I talked about in the article, namely Schneider's acquisition of Square D, or the Nestle transaction that you just heard about, their acquisition where they pushed debt into the U.S. target company. The ability to lever their acquisition, and to strip interest out of their U.S. affiliates by intercompany transactions, allowed a significant portion of their U.S. business profits to leave the U.S. and to go to a low-taxed country.

And so, I think that we are getting enough anecdotal evidence, both from the testimony you have heard today, the subsequent history of what the inverted companies' tax rates look like compared to their other competitors, and just knowing that the tax planning tools between inverted companies and foreign-owned companies are the same.

I think that the inverted companies have done this committee a great service. They have given us a knowledge about the cause-effect dynamics of why their tax rates went down, and why it went down is because they are a foreign company with the same tax planning tools as al other foreign companies.

Mr. NEAL. Mr. Stricof, you—and then Mr. Hufbauer, would you like to offer your analysis?

Mr. STRICOF. Sure, thanks. I think there are some very valid points that have been made. I think that when you look at the competitive advantage a foreign company may have, a lot of that has to do with capital flows, whether you talk about them as base-eroding payments, or whatever. And one of the major problems the U.S. entities have, as compared to their global competitors, would be solved effectively by territorial taxation.

What happens in, say, Nestle—and I am not trying to use Nestle, other than everybody else has, so I mean no disparaging remarks. What happens; Nestle decides to make an acquisition, or any com-

pany decides to make an acquisition that is based in any country in the world except the U.S. How are they going to fund that acquisition?

They can take money from all the other countries they have in the world, repatriate it to their home country at virtually zero taxation; in most of the free world such a repatriation of profits is either tax free or they have a 95 percent exemption of that income coming back, which they can redeploy in the acquisition.

What I find—and I do strategic acquisitions, I don't do leveraged buy-outs or other things like that, I do a lot of strategic work—I find that when you are doing acquisition planning, who is going to win that acquisition? U.S. companies go after the target; foreign companies go after that target. Whoever has the best synergies from a true business perspective is who actually wins the deal. It has very little to do with the taxes.

If there are base-eroding type payments in the form of interest expense that comes back to the parent country, it just allows the foreign multinational to redeploy that cash. And therefore, they have more cash available to do the acquisition. I don't think it is really the fact that it is zero-taxed as much as that they can get the money back to where they need it to be.

Mr. NEAL. Mr. Hufbauer.

Mr. HUFBAUER. Thank you. About 40 years ago, when I was in the Treasury, one of my early tax articles was on the theoretical possibility of inversion. Well, it was theoretical in the 1970s and, as Professor Wells and others have said, it is something of a reality now.

But my recommendation, as I have said more than once, is to improve our own tax system as the major answer, rather than additional moats, as the major answer. I am not saying that we shouldn't have some moats—and we have some which have been put in by Congress—but the big issue is not the handful of corporations which invert. Yes, that is an issue. But the big issue are the global 1,000 corporations of 2020, and where they will locate.

I believe there is a very strong synergy between corporate headquarters and R&D and the rest of the economy. We want as many of these corporations who are yet to grow and yet to come on the scene to locate here, in the United States. And our tax system is a disadvantage, for reasons that have been said in more detail than I can say.

And we should think about that, and really concentrate, in terms of inversion, on what I would call crystal clear abuses, but not try to reinvent, in its erstwhile glory, the worldwide tax system as it was conceived by Peggy Richmond, a very distinguished scholar of an earlier era, back in the 1960s. We are not going to go back to that world. Thank you very much.

Mr. NEAL. Mr. Wells, there are some who have suggested that if we tighten the rules on earnings strippings, it is going to discourage foreign investment. What is your take?

Mr. WELLS. Okay, I have several comments. The first is that if an investor is told that they will pay the same taxes every other American, whether they are foreign-owned or domestic-owned, and that is a discouragement, well, then we have a fundamental problem, Neal. Because if we will give someone a tax preference in

order to be here, then we should expect all of the economic activity to be transformed. Mr. Stricof and others in the accounting firms will do a fantastic job of reshaping America into the most preferred investor into this country.

So, we have to start with the premise, in my mind, that we do not want to discriminate against foreign investment, but we cannot allow economic participants to have an unequal playing field.

Now, on the point earlier about residual profits and royalties, I think that is an issue for this committee to think through. We relinquished our source country taxation right to tax residual profits because of what was said earlier, because we expected more to come back to the U.S. Treasury, and we expected the other home countries to tax those earnings.

But if your committee sees that the other country is not taxing those residual profits, that they are escaping taxation and result in no taxation, then the fundamental reason we decided to not have source-based taxation—namely, to allow the other country the primary right to tax these profits at their normal rate—that assumption is off. It is wrong.

And so, if we are going to have comparable treatment in a world where the other country doesn't want the deference, then you have to think, well, what does today's world look like? In the post-World War I era when we had these treaties coming about, all of the World War I victors were wanting to fund their war debt, and they would tax the residual profits. But as Mr. Hufbauer has said, residency taxation is now leaving the earth.

And so, why do we believe that other countries will tax this offshore income? And if it is a competitive disadvantage, then we must do something about it.

So, what I would urge you to think through is not just the question of what we are going to discourage. We need to have comparable treatment. And I don't think that comparable treatment is going to cause anyone to not want to invest in the United States.

Mr. NEAL. Thank you. Mr. Stricof or Mr. Hufbauer, would you care to comment, as well?

Mr. STRICOF. One has to decide what is the goal. And if the goal is to encourage foreign investment into the U.S., to promote job creation, to promote capital investment, anything that one does that restricts that will prevent that result from occurring. That is what I think.

If you look at the companies that are making the most investments in this country, you look again—just like I said in my earlier response to a question, you look at Germany, you look at the UK, you look at all these other countries. The capital flows are going back to those countries in a tax-efficient a manner. I guess the concept that is being expressed by Mr. Wells is the U.S. should be the tax police of the world, which we have heard about before. I don't know what makes the U.S. the tax police of the world.

If the foreign jurisdictions that are earning the income choose to tax that income or not, why are we trying to interfere with that? I understand that in treaties, treaties are bilateral, and that they are supposed to ensure that there is no double-taxation in the world. The U.S. side of the deductions are appropriate levels of deductions. That is what I have testified to already, that is what

Treasury effectively had no qualms with in the case of historic investment into the United States. If those other countries choose to allow their own country—not to tax that income, why do we care?

Mr. NEAL. Mr. Hufbauer.

Mr. HUFBAUER. Thank you. Let me approach the question from 30,000 feet, starting at the Sierra Nevada between California and Nevada.

I think it is a matter of sovereignty that Nevada has decided not to have a corporate tax, and it is a matter of sovereignty that California has, I believe, one of the highest corporate taxes amongst the 50 states.

I don't regard a low level of corporate taxes as an unfair advantage. It is a matter of what is within the competence of state jurisdiction or national jurisdiction. So, in my view, if Ireland has a 12½ percent rate, that is not Germany's problem. And it is not the U.S. problem. That is Ireland's own decision. And I do not think it is our job to try to recapture the income which was somehow not taxed by Ireland.

Or, we can go to a more extreme case, the Caymans. They have a zero corporate tax. I don't think it is our job to somehow try to claw back or cajole the Cayman Islands into coming up to the U.S. corporate tax rate.

I do feel it is appropriate for the United States to go after money laundering, drug money and personal tax evasion. But I am pretty strong that the choice of a corporate tax rate between zero and whatever is a national sovereign decision, or a state decision.

And then I back up from that, still staying at 30,000 feet, to say that tax competition is healthy for the world, yes healthy for the world. Tax competition at the corporate level, I think, is good for us because it takes us off the notion that, as Senator Long, whom I remember quite well, said, "Don't tax you, don't tax me, tax the fellow behind the tree." Well, tax competition takes us away from that notion that there is somebody out there who is going to pay taxes, but not us.

So, that is my 30,000 view. Thank you very much.

Mr. NEAL. Well, let me meet you at 30,000 feet. Would you—and I am interested in your comment, obviously—would you argue that a $27,000 post office box in the Cayman Islands or another foreign jurisdiction is a legitimate corporate address?

Mr. HUFBAUER. It depends on the kind of activity that is going on there. But according to data that I looked at, there are far more post box corporations in Delaware than in Cayman. And I believe that that is within the appropriate rules of a country. I am not fronting for drug lords and money launderers. But if it is open, transparent, yes. It is okay in Delaware, it is okay in Cayman, by my view.

Mr. NEAL. So you would suggest that an American corporation that decides to set up shop—use the example of Bermuda—with simply a post office box and no employees is a legitimate undertaking?

Mr. HUFBAUER. If that is what the Bermuda law permits, yes, I will assume that it is. I am not certain on Bermuda law there. But if that is a legitimate corporation under Bermuda law, yes.

Mr. NEAL. And how am I to respond to those moms and dads who have children in Afghanistan and Iraq, that those post office boxes are used to evade American taxes?

Mr. HUFBAUER. Well, if you define it as evasion, which takes me back to the money laundering or improper reporting, absence of transparency, it is totally inappropriate.

But the threshold question: Is it evasion? And here we come to a related question, the degree of transparency. And as I understand it—I won't go to Bermuda, but for Cayman, as I understand it, they have a very tight relationship with our Justice Department, reporting all financial transactions in which the Justice Department is interested, which probably reflects what the Treasury Department is interested in, as well.

And so, if we are not into that realm of transactions which are what I would call evasion, yes. It is all right.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman TIBERI. Gentleman from North Dakota, Mr. Berg, is recognized.

Mr. BERG. Thank you, Mr. Chairman. I appreciate the panelists. Thanks for being here.

I would like to crank it up to 50,000 feet, though. You know, I have been watching tax policy for 30 years. I have just been in congress a few short months but, I mean, I couldn't—I just want to make the point I think there is always unintended consequences. I don't care how much time and effort Congress and staff and people can do to write tax law, you just can't get it perfect. And whatever you do, you create opportunities—call them loopholes or call them whatever—but the code is what it is.

And again, as we are talking about, you know, interest stripping, as we are talking about how, again, people are following the law, but they are doing it because we have a law that—saying we are not going to tax you if you do these things, and you try and fix those, you create other problems.

And I guess I just wanted to make the point that I think, you know, our chairman here and Chairman Camp, our objective is to simplify the whole tax structure. If we, in fact, get back to a real simple—again, 25 percent, rather than a 35 percent, it makes us more competitive. And rather than having chapters and chapters and reams and reams of exemptions, maybe we don't have as many exemptions. Maybe it is pretty simple, it is pretty black and white, working towards a territorial system.

And just again, simplifying the tax law—again, for those people that make money in tax law and the changes in the regulations, that may not be good, short term. But I just believe that that would, again, help business focus on making decisions that are good for business and good for customers and good for profits, and not necessarily having to second guess those business decisions, based on taxation.

So, having said all that, I would like to kind of step back also. And I believe in best practices. And so we have talked a lot about what we can do to change. But I would like to look at the other developed countries around the globe, and say—and I would like each of you to kind of respond to this. And I don't want to look at today and I don't want to look at yesterday, but I want to look to

the future and say which countries have the right tax environment that we are going to have to compete with in the future, here in the United States?

And so, if we just could—again, if you could say, "Here is a country that I think is going to be where capital is going to flock to, what could we"—just share that with this committee, and so we can say, okay, here is something we ought to look to.

Mr. HUFBAUER. Thank you. That is a good 50,000-foot question.

I guess I would say the big missing part of the U.S. system—and I understand the unpopularity of it—is a national consumption tax coming under various names: a goods and services tax, a value-added tax. And we are, again, way out of step with the world. I think it is quite harmful to our position as an exporter. Also it makes it very difficult to collect the revenue which our country apparently needs to run the projects that we want.

So, what I would look to would be a country such as Canada, which has put in a GST. The rate isn't terribly high, but it is a revenue raiser. Canada has reduced its corporate tax. And, importantly, what Canada has done on the corporate tax—and this comes from the Canadian constitutional system—is to let about half be collected by the provinces. And I think that is quite appropriate, because then provinces can decide, in my model of tax competition, whether they want a high corporate tax, which Ontario does, or a low one, which Alberta does. Let them decide. Alberta relies more on oil royalties, obviously.

So, I would put Canada as a model in the business tax area. I am not talking about the personal tax, and I will not get into the personal tax. I would also name Australia as a model. Australia has done a lot of reform over the years, rather similar to Canada. I don't think the U.S. can emulate Ireland. I think Ireland had a great model for a small country. I don't think we can go down there probably in the near future.

I do want to emphasize—and this is possibly in response to Congressman Neal's question to what Mr. Wells says, I don't want to tolerate what used to be called personal foreign holding companies way back in the 1930s, which become incorporated pocketbooks for U.S. individuals to take their money abroad. I really want to keep the personal tax system here.

And I also am quite sympathetic to putting withholding taxes on interest payments on a negotiated basis under treaties. Thank you.

Mr. BERG. Thank you.

Mr. STRICOF. For somebody that could only fly at, what, about 10,000 feet, you are doing pretty good at getting to 50,000 feet.

I have to repeat one statement before I continue, and that is that I don't know anything about tax policy, I am not good at tax policy, and I am not promoting any specific tax policy. But I can tell you what I think is going on as a best practice method in various countries.

And, again, I go back to the developed world and what are they doing? They have all dropped their corporate tax rates, universally. Even Japan is talking about, or has already, dropped their corporate tax rate. Everybody with possibly the exception of Japan—has instituted, as well, a major R&D incentive.

I think that one of the things that made this country great and allowed us to make so much external investment in the 1960s is we owned the intellectual property of the world. We were the most innovative, the most creative, best educated, you name it. That was the United States. And, therefore, in the 1960s we expanded dramatically around the world.

So, how do we make that happen? I can't tell you. That is a policy issue. But I can tell you that whoever wins that, 20 years from now will be looking back and be the ones that are saying, "Yes, I did it right."

Mr. WELLS. Representative Berg, I think dropping the rates is probably a good suggestion. Whether territorial is the answer with safeguards to the U.S. tax base or a worldwide regime, that is something that—I think either regime could work—but the committee needs to be very careful about.

I think that we don't want to be the tax police of the world. But we are out of the 20th century, and the 20th century thought was that we should allow base erosion payments because the other country will tax the residual profits on a residency basis, and we don't want double taxation. The world today is double "no taxation." And to the extent that double "no taxation" is a loss of revenue, that is unfortunate for the congress.

But what I am most concerned about, and what I hope you leave the hearing with is, if one competitor has a no-tax result, and it is a significant part of their U.S. business, that is a competitiveness issue. And that is more than just losing revenue that is desperately needed for our country. That is a competitiveness issue.

So, as you think about designing a system, if we can have everyone pay a single level of tax, and defer or allow profits to be transferred or stripped to an offshore location only when it is a real country that is really going to subject those profits to a tax at the 20 to 30 percent rate that you have been discussing, then that is fine.

But if someone is able to strip profits to create zero taxed income, and they are the competitor that can do it and the next competitor cannot, then I can tell you what the next generation of businesses in America is going to look like. They are going to look like the first person.

And that is what I would urge you to consider, that as we think about what corporate reform looks like, that it should attempt to get at an equalized tax rate among all economic participants, or we would expect to be the one creating the economic participants of the next generation.

Mr. BERG. Thank you. I have one other follow-up question. And again, everyone is looking at risk versus return. We could have high tax rates, but if every foreign investor was guaranteed a super return, we would have all kinds of money. And you know, having said that, we are assuming that things are—the return is pretty much even among several countries. How do we encourage—and other than the rates, regulation, I think, has a place in this, as well.

And I just want to know if there is any—you know, over the last—I guess the Obama Administration, if there is any regulatory

changes recently that you have seen that would inhibit that investment from coming into the United States.

Again, if we could just—each of you respond, or any comments on that.

Mr. HUFBAUER. You are right about the risk and return issue. And this is one of the great strengths of the United States. We have a very stable legal system. Property is highly respected, compared to other countries. Certainly Switzerland would be in the same category, but the legal regime of property rights really cuts down the risk here, compared to a great many countries in the world. So, that is one of our strengths.

Now, where do we have problems? I am not sure that the Obama Administration has done anything out of line in this respect. I think that our tort system, which is being corrected, I believe, by the Supreme Court—and I applauded the recent Wal-Mart decision—does create a certain amount of risk for class action suits, and that sort of thing. I think that risk is actually on the way down now. That is not because of the Administration, it is really the courts.

I know there has been a lot of talk about the Dodd-Frank bill, and has that made banks less willing to loan, and so forth and so on. I regard that law as a work in progress, where I am sure Congress will return to it if, in fact, it does discourage lending to small and medium-sized companies. That I have actually looked at. I think the lending situation today is more because of the financial crisis than because of any new legislation. But that may be an area in the future. Let me stop there. Thank you.

Chairman TIBERI. The gentleman may answer the question.

Mr. STRICOF. Well, if I can't talk about policy, I certainly can't talk about regulation.

[Laughter.]

Mr. STRICOF. But what I can do is applaud the effort towards simplification. And I think anything that simplifies our tax laws and the enforcement of our tax laws is certainly going to be welcome by the business community, as a whole. It has nothing to do with inbound versus outbound. It is just effectively talking myself partially out of a job, but I think anything that goes for simplification is very good.

But I would caution that the last time somebody decided to have a tax bill that was labeled "simplification" in it, they took the definition—I think it may have been—I can't remember if it was gross income or taxable income from—it must have been taxable income—from the definition of gross income minus deductions equals taxable income to a three-page definition.

Mr. WELLS. I have three quick points. And, again, I am not an economist like Mr. Hufbauer. He is probably the most relevant person to ask. But as a citizen, to me, I think broadening the tax base and making it simple is a wonderful goal. Everyone should bear the same or as close to the same a tax for similar activity.

Second, a sustainable fiscal budget. I think that one of the biggest challenges for foreign investors today is knowing the fiscal situation of the U.S. Government. And I think that you are getting pulled 100 different directions as to what to do. But I think that foreign investors would be overjoyed to believe that the fiscal crisis

that may be looming for the country has been dealt with thoughtfully.

And I think the last point would be to know what tax reform will be. And I think that is not to put pressure on this committee. It needs to be thoughtful, and you need to take the time to do it exactly right. But I think if companies and other countries knew that our fiscal house was in order, and they knew what our tax structure was going to be, and that the tax base was as broad and as simple as possible, and we treated everyone comparably, then I think that would achieve the best result for the country.

Mr. BERG. Sounds simple.

Chairman TIBERI. Great way to end today's hearing. This concludes today's hearing.

Please be advised that Members may submit written questions to the witnesses. Those questions and the witnesses' answers will be made part of the record.

Thank you. Thank you to the three of you for some really, really good and educational testimony, a discussion, and I believe it helps us, again, get more information as we want to move forward on comprehensive tax reform. I appreciate your time.

This concludes today's hearing.

[Whereupon, at 12:37 p.m., the subcommittee was adjourned.]

[Submissions for the Record follow:]

Prepared Statement of The Honorable Ms. Berkley

Rep. Shelley Berkley
Statement for the Record
House Ways and Means Select Revenue Subcommittee Hearing on
Tax Reform and Foreign Investment in the United States
June 23, 2011

Today's hearing focuses on the role of foreign direct investment in expanding the U.S. economy and creating jobs for American workers. While that has been primarily focused on the tax environment for foreign investors, I want to call my colleagues' attention to the value that foreign visitors bring to the U.S. economy each year.

Countless reports have shown how the travel industry bolsters job creation here at home. According to the U.S. Travel Association, inbound travel to the U.S. currently supports 1.8 million U.S. jobs and more than $134 billion in direct travel spending in the United States. Overseas visitors spend on average $4000 in the U.S. per visit, so if we can increase the number of visitors to the U.S. each year, we will create even more jobs and further strengthen our economy.

There are several easy ways we can increase the number of foreign travelers to the United States, at little or no cost to U.S. taxpayers, including reducing visa interview wait times, improving planning at our consular offices around the world and expanding the Visa Waiver Program. There are numerous countries around the globe that are eager to send more visitors to the U.S. each year, but we simply lack the consular staff and visas to allow them all to come here. Shame on us. We should never be turning visitors away, and certainly not in this economy. We should be welcoming them, as they are a boon to our public diplomacy efforts, a boon to our economy and a boon to our working families who need jobs and a secure economic future.

Prepared Statement of Brian Dooley

Brian Dooley
CERTIFIED PUBLIC ACCOUNTANT
P.O. BOX 685, SILVERADO, CA 92676

The Honorable Chairman Tiber
House Ways and Means Committee
Via email, only

Regarding Tax Reform and Foreign Investment in the United States

Dear Honorable Chairman Tiberi
and other members of the House
Ways and Means Committee:

Thank you for this opportunity to provide my written comments on tax reform of foreign direct investments in the United States of America.

As a certified public accountant with a public accounting practice concentrating on helping cross border privately owned businesses, I am concerned by the prejudice against foreign direct investments found in the Internal Revenue Code ("IRC").

These prejudices manifest themselves in three areas.
They are:

Discriminatory Strict Laws Forcing Double Taxation
aka "BRANCH PROFITS TAX"

Enacted in 1986, the branch profits tax was modeled after the domestic accumulated earnings and profits tax, section 531.

Only the foreign business is subject to the strict double taxation rules (explained below) of the branch profits tax. In both the friendship, navigation and commerce treaties and tax treaties America promise not to discriminate against the foreign business. Yet, in practice, America does discriminate, as I will explain below.

Section 531 and the concept of double taxation of privately owned business have their genesis in the 1954 IRC. Changes in the IRC allowing Subchapter S corporations and single member limited liability companies have made section 531 irrelevant. Because of section 531, rarely does small business select corporation taxation under Subchapter

C[1].

The regulations for section 531 allows profits to be accumulated for reasonable needs of the business, redemption of shareholders and the sophisticated model (known as the "Bardahl Formula") that allows a practical accumulation of profits for business operations.

The stated purpose of the branch profits tax was to bring about a similar tax treatment of foreign corporations engaged in a United States business with domestic corporations. Further Congress and the Senate wanted to promote neutrality by subjecting the U.S. branch earnings of a foreign corporation to a second level of U.S. tax upon a "deemed remittance."

As you will discover no real remittance to a foreign home office is required for the tax to apply. Merely the accumulation of profits beyond what the IRS deems reasonable causes the tax to be assessed. The IRS makes this determination using the IRS' hindsight. In writing the branch profits tax regulations, the IRS could have included the exceptions found in section 531. However, the branch profit tax income regulations exclude all of the rules found in the section 531 regulations.

Instead regulation 1.884-1(d)(2)(v) provides the IRS the authority to deem that a remittance occurred. The regulation removes any bank deposit from the definition of a branch asset with the following text- "Any other deposit or credit balance shall only be treated as a U.S. asset if the deposit or credit balance is *needed*[2] in a U.S. trade or business within the meaning of section 1.864-4(c)(2)(iii)(a)."

Unlike section 531, the branch profit tax refers to a regulation (1.864-4) that is not related to the reasonable needs of a business to accumulated working capital. Regulation 1.864-4 determines the source of income and not the reasonable needs of a business to accumulate working capital.

The assumptions used by Congress and the Senate in 1986 no longer exist. Privately owned domestic businesses do not incur double taxation. They operate as either sole proprietorships or as pass-through entities. They choose this method not only to avoid double taxation but just as importantly to avoid the overly complex tax law of Subchapter C.

Publically owned businesses rarely incur double taxation. The average dividend rate of the Standard and Poor's 500 corporations is approximately two percent. Section 531 has never been applied to a corporation listed on the major American stock exchanges.

Further the branch profits tax applies to the foreign corporation with a branch office in America or owning a partnership share (which includes ownership in a domestic limited

[1] An exception is a "loan out" corporation. However, loan out corporations zero out their taxable income with a combination of compensation, qualified retirement plan contributions and medical benefits.
[2] Emphasis added by author.

liability company). Where the foreign corporation makes the United States its headquarters, the owners are shocked to discover the branch profits tax applies even though there is no foreign activity and all of the activity is in America.

Section 884 consists of three main parts:
1. Branch profits tax on certain earnings of a foreign corporation's U.S. trade or business,
2. Branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business and
3. An anti-treaty shopping rule

A foreign corporation is subject to Section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States ("ECI").[3]

(1) The branch profits tax

Section 1.884-1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, Section 884(a) imposes a 30 percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not "deemed" reinvested in a U.S. trade or business by the close of the taxable year, or that are "deemed" disinvested in a later taxable year.

Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings are deemed reinvested in, or disinvested from, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax.

The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. This amount is the reduction in the net worth of the U.S. branch. Form 1120F includes a place for the computation of the reduction of the net worth. One may feel that by merely keeping all of the net profits on the U.S. branch in America, one can avoid the tax on the dividend equivalent. However, American tax law looks at why assets are kept in the branch. If a foreign corporation cannot prove that the assets are in the branch for an active business reason, then the dividend equivalent tax applies.

The tax rate is 30 percent unless reduced by tax treaty.

Section 1.884-2 contains special rules relating to the effect on the branch profits tax upon the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary. In theory, the tax

[3] An international organization (as defined in Section 7701(a)(18)) is not subject to the branch profits tax by reason of Section 884(c)(5). A foreign government treated as a corporate resident of its country of residence under Section 892(a)(3) shall be treated as a corporation for the purposes of Section 884. In the case of branch interest, Section 884 applies only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in Section 1.884-1(d)(1)(iii).

does not apply. However, as explained below, this regulation has many esoteric and overly complex exceptions that create taxation.

(2) The branch-level interest tax.

Section 1.884-4 provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business of a foreign corporation ("branch interest," as defined in Section 1.884-4(b)) is treated as if it was paid by a domestic corporation and may be subject to tax under Section 871(a) or 881, and to withholding under Section 1441 or 1442. In addition, if the interest apportioned to ECI exceeds branch interest, the excess is treated as interest paid to the foreign corporation by a wholly owned domestic corporation and is subject to tax under Section 881(a).

This overly complex law is a surprise attack on the privately owned foreign direct investment. International financing is desirable in most other countries except for America.

(3) Anti-Treaty Shopping

Section 1.884-5 contains anti-treaty shopping rules. The concept is that the foreign entity must pay tax to the treaty jurisdiction and must be owned by residents of the treaty jurisdiction. The term "qualified resident" is used to designate such a person. A foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

The Double Whammy - Regulation Section 1.864-4's Example 4

The IRC not only taxes the foreign person on its U.S. business, it taxes on its income attributed to its foreign offices. This is income is taxed not just once by the United States, but twice.

Read this example from the regulations.

"Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines."

"During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968."

"As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States."

"The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year **from sales of wine by the home office**, is treated as effectively connected for that year with the conduct of a business in the United States by S."

A successful foreign business is not going to subject their foreign home office's sales to both U.S. income and U.S. branch profits tax totaling sixty-five percent (plus a state income tax) by making a foreign direct investment.

REGULATORY SHORT COMINGS

Businesses flee uncertainty, especially when the uncertainty is a thirty percent discriminatory tax that does not apply to its domestic competition. This tax destroys working capital. Without working capital, a business ceases to be a going concern.

The regulations fall short in providing guidance based upon the comparable domestic law, section 531. The consequence of the absence of a regulation providing the benefits found in section 531 is that reasonable taxation rules of section 531 are not available. The branch profits tax becomes an off or on switch tax law that only applies to foreign corporations.

Further, complexity surrounds the termination of a United States branch. Regulation section 1.884-2 explains the termination rules. Every business needs to know its exit plan. Uncertainty as to the exit plan can prevent a foreign direct investment. The concepts found in this regulation are overly complex and esoteric.

Here are some of the paragraph headings relating to the ending of a U.S. business by a foreign corporation: "Property subject to reinvestment prohibition rule", "Direct or indirect use of U.S. assets", "Complete termination in the case of a section 338 election", "Coordination with second-level withholding tax"[4], "Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs", "Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor", "Inapplicability of paragraph (a)(1) of this section to section 351 transactions, Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs", "Amount of the transferor's effectively connected earnings" and "Profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee" and "Certain transactions with respect to a domestic subsidiary".

CONFISCATORY ESTATE TAXES ON THE OWNERS OF FOREIGN DIRECT INVESTMENTS

Foreign direct investments by non-publically traded corporations expose the investor to a confiscatory estate tax. The non-domiciled alien has an estate tax exemption valued at $60,000.

The non-domiciled alien is also subject to gift tax and generation skipping tax with a limited annual deduction and without the five million dollar exclusion.

The non-domiciled alien does not have the unlimited marital deduction.

[4] By the way, there is to be no second level withholding when the branch profit tax applies or has applied.

Investments in United States property are included in the taxable estate of a nondomicile. Until a few years ago, tax professionals believed that the ownership of shares of a foreign corporation by a non-domicile alien was exempt from United States estate taxes.

However, since the series of tax court decisions—*Strangi, Albert, Estate of et al. v. Comm.* (05-20-2003); *Bongard, Wayne C., Estate of v. Comm.* (03-15-2005); *Stone, Eugene E., Estate of III, et al. v.* Comm. (11-07-2003); *Harper, Morton B., Estate of v. Comm.* (05-15-2002); and *Kelley, Webster E., Estate of et al. v. Comm.* (10-11-2005)—this is no longer the belief.

In these cases, the court ruled that IRC Section 2036 requires that assets held by any entity be included in the taxable estate of any decedent who transferred property to the entity. Under Section 2036, the property transferred is included in the decedent's taxable estate when he or she retained the right to the income.

The foreign investor owning all or substantially all of the stock of a foreign corporation is considered to own the corporate assets under section 2036 (retained life estates). Under the case law, stock owned by a family subjects each person to estate tax inclusion under section 2036. In these cases, as in most family business, the family planned to withdraw the profits of the business for personal use and enjoyment.

Section 2036 specially covers the use and/or enjoyment of property.

CONCLUSION

The IRC makes doing business in the United States undesirable when compared to countries such as the United Kingdom, Switzerland[5] and The Netherlands in Europe and Singapore and Honk Kong in Asia.

Each of these other countries does not subject the foreign person to a confiscatory estate tax and double taxation on the successful foreign direct business. Further, the branch profits tax law on a business termination is so overly complex and unclear, that the foreign investor cannot determine his tax upon leaving the United States.

The cost of United States tax administration and a sixty five percent tax rate discourages direct foreign investment.

Respectfully submitted,

Brian Dooley, CPA, MBT

[5] For example, from 2004 to 2006 more than 1,000 foreign companies moved to Switzerland (on this link), a country with a population of less than eight million people.

Prepared Statement of Mayer Brown LLP

MAYER·BROWN

Mayer Brown LLP
1999 K Street, N.W.
Washington, D.C. 20006-1101

Main Tel +1 202 263 3000
Main Fax +1 202 263 3300
www.mayerbrown.com

July 5, 2011

The Honorable Patrick J. Tiberi, Chair
The Honorable Richard E. Neal, Ranking Member
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1101 Longworth House Office Building
Washington, D.C. 2015

Dear Chairman Tiberi and Ranking Member Neal:

We are submitting this letter for the record of the Subcommittee's hearing on June 23, 2011 on "Tax Reform and Foreign Investment in the United States." We write to underscore our policy and legal concerns with a number of proposals to dramatically increase taxes on the use of foreign affiliated reinsurance, including the proposal contained in the Administration's FY 2012 Budget. We believe that such proposals violate U.S. obligations under the World Trade Organization's ("WTO") General Agreement on Trade in Services ("GATS"). Many such proposals are discriminatory in nature, or impose conditions on access to the U.S. market that are incompatible with U.S. commitments. Enacting such proposals would leave many critical U.S. export sectors vulnerable to WTO-authorized retaliation. It would also damage the ability – and credibility - of the U.S. in its efforts to open foreign markets to U.S. insurance and reinsurance services. Finally, restricting the supply of reinsurance products would cause harm to U.S. insurance consumers in certain regions of the country and key sectors of the U.S. economy.

It is possible for the U.S. to utilize the exception in the GATS from national treatment obligations if the measure is merely to safeguard the member's tax base. However, to qualify for the exception, any measure cannot apply (as the GATS states) "in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services."

As a practical matter, this means that a proposal cannot arbitrarily restrict competition and protect domestic servicers. Any proposal must legitimately distinguish between normal risk management practiced by all insurance companies and activity driven solely by inappropriate tax behavior. It must also take into account taxes paid in the home country of the foreign reinsurer, so as to actually determine whether any tax incentives actually exist. And because any reinsurance is the movement not only of premiums but also risk (i.e., the future possibility of profits or losses), any proposal must account for claim payouts in a non-discriminatory fashion.

Mayer Brown LLP operates in combination with our associated English limited liability partnership and Hong Kong partnership (and its associated entities in Asia) and is associated with Tauil & Chequer Advogados, a Brazilian law partnership.

At a time when the U.S. is rightly pressing a number of emerging markets to maintain competition in the insurance sector, meeting our WTO commitments in the financial services arena is critically important. In addition, these are the export markets the U.S. needs to meet the President's goal of doubling U.S. exports.

In short, now is not the time to have a retreat in global U.S. leadership in the services sector. Whether it is in the context of "pay-fors" for any number of worthy legislative proposals, or as a part of a larger reform of the U.S. tax code, WTO obligations and the U.S. commitment to competition should bear heavily in any analysis. We hope and trust you will keep these considerations in mind.

With best regards,

Mickey Kantor

Susan C. Schwab

Prepared Statement of Overseas Shipholding Group

STATEMENT FOR THE RECORD

OF

ERIC F. SMITH
VICE PRESIDENT & HEAD OF GOVERNMENT AFFAIRS
OVERSEAS SHIPHOLDING GROUP, INC.

FOR THE HEARING ON

"TAX REFORM AND FOREIGN INVESTMENT IN THE UNITED STATES"

BEFORE

THE U.S. HOUSE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES

JUNE 23, 2011

302 Knights Run Ave, Suite 1200, Tampa, Florida 33602
813.209.0602 • esmith@osg.com

Chairman Tiberi, Ranking Member Neal, and members of the House Ways and Means Select Revenue Measures Subcommittee, thank you for the opportunity to submit this statement for the record on behalf of the Overseas Shipping Group, Inc. ("OSG"). We applaud the Committee and Subcommittee for their work on the critical issue of tax reform.

The issue of incentivizing foreign direct investment in the U.S. is an important consideration as tax reform progresses. Our statement focuses on a related topic – a provision in the current U.S. tax code that is effectively encouraging the investment of significant capital of U.S. shipping companies in foreign assets. We applaud Chairman Tiberi for his leadership in introducing H.R. 1031, the "American Shipping Reinvestment Act of 2011" ("ASRA"), which would address this anomaly. Companion legislation, S. 626, has been introduced in the Senate. We strongly urge enactment of this important bipartisan legislation, which would repeal this antiquated law, provide for an immediate investment in our nation's maritime industry, and stimulate U.S. economic activity and job growth during this fragile time in the country's economic recovery.

THE U.S. MARITIME INDUSTRY

The U.S. maritime industry plays a crucial role in the U.S. economy, serving as the backbone of modern transportation and making possible the transport of raw materials, petroleum products, affordable food, and manufactured goods. The maritime industry is an important contributor to the U.S. economy, sustaining thousands of American jobs in the shipbuilding, seagoing, and related trades. A recent PriceWaterhouseCoopers analysis estimated that, in 2009, U.S. flag ships that carry goods between U.S. ports – which must be U.S.-owned, built, and crewed – accounted for approximately 74,000 jobs in the U.S. economy, resulting in $36.4 billion in U.S. economic output and $6.5 billion in U.S. labor compensation. Another approximately 426,000 jobs arose from indirect and induced effects, accounting for $35.5 billion in U.S. economic output and $22.6 billion in U.S. labor compensation.

The U.S. maritime industry is also an essential component of our national security. The U.S. flag fleet supports a shipbuilding defense industrial base and pool of qualified seafarers and shipping assets needed for military sealift in times of war or national emergency. For example, U.S. flag commercial vessels and their American crews transported the majority of cargoes – more than 25 million measurement tons – in support of Operations Enduring Freedom and Iraqi Freedom during the period of 2002-2008.

Additionally, American-owned companies' international ships are part of what is called the Effective U.S. Controlled Fleet ("EUSC fleet"), or the fleet of merchant vessels, registered in certain foreign nations, that are available for requisition, use, or charter by the U.S. government in the event of war or national emergency. However, a 2002 study commissioned by the Department of Defense ("DOD") and performed by professors at the Massachusetts Institute of Technology found that the EUSC fleet dropped by 38 percent in terms of numbers of ships and nearly 55 percent in terms of deadweight tonnage between 1986 and 2000.

This finding is reflective of the decline in American-owned international shipping. American-owned shipping companies used to be a major transportation sector on the world's

oceans. However, progress has been made in recent years to address international tax inequities affecting the shipping industry and to help rebuild the U.S.-flag shipping industry. Through the enactment of a tonnage tax regime and restoration of deferral in 2004, significant progress has been made, but more needs to be done.

THE OVERSEAS SHIPHOLDING GROUP, INC.

OSG is a market leader in global energy transportation services. OSG owns and operates an International Flag and U.S. flag fleet of 118 vessels made up of 109 operating vessels and nine under construction aggregating 12.1 million deadweight tons. The fleet transports crude oil, petroleum products and gas in the U.S. and throughout the world.

Founded in 1948, OSG has been successful through multiple shipping cycles. This success is the result of OSG's vision, breadth and experience, emphasis on quality and the safety of the environment, the size and diversity of its fleet, and the skills and commitment of its professional staff and crews.

OSG is based in New York and has offices in Athens, Houston, London, Manila, Montreal, Newark, Newcastle, Singapore and Tampa. It has 3,500 employees, of which 3,050 are seafarers.

THE AMERICAN SHIPPING REINVESTMENT ACT

ASRA addresses the unintended consequence of an antiquated tax provision enacted in 1975. Under the 1970s tax provision, U.S. shipping companies must maintain investments in qualified foreign shipping assets made between 1975 and 1986.

More specifically, between 1975 and 1986, "foreign base company shipping income" was included as a category of subpart F income. Under this provision, subpart F income generally did not include foreign base company shipping income to the extent it was reinvested during the taxable year in certain qualified shipping investments. If, however, in a subsequent year a net decrease in qualified shipping investments occurred, the amount of previously excluded subpart F income equal to such decrease was treated as subpart F income. In other words, any net decrease in these investments resulted in an immediate tax penalty.

Although the deferral for shipping income provision was completely repealed in 1986, the pre-1987 net investment in qualified shipping assets under section 955 of the tax code was retained. As a result, decreases in investments in qualified shipping operations from pre-1987 level continue to trigger subpart F income. These rules apply even after section 415 of the American Jobs Creation Act of 2004 ("2004 Jobs Act") repealed the subpart F rules applicable to foreign base company shipping income.

This quirk in the tax law has created a perverse system that distorts the investment decisions and increases the transaction costs of U.S. companies, particularly with respect to structuring a financing strategy or deciding whether to acquire or divest qualified shipping assets. For example, because of the method for calculating amounts invested in qualified shipping assets, a company's investment may decrease due to the depreciation of its assets, rather than due

to any affirmative action that it takes to withdraw from shipping. In such circumstances, a company may be forced to invest its resources in a way that is not economically optimal in order to avoid triggering subpart F income, regardless of market conditions or business need. Additionally, Subpart F inclusion may triggered if a company issues debt to invest in non-shipping operations, thereby deterring a company from financing the expansion and diversification of their enterprises. At end, even though these companies have a strong desire to reinvest their foreign earnings in the U.S. and inject money into the economy, they are effectively unable to do so. Instead, the practical consequence is that these earnings are permanently invested abroad.

The bipartisan ASRA legislation would repeal the outdated 1970s tax provision. Additionally, ASRA would provide U.S. shipping companies with a one-time opportunity to receive foreign source earnings at a reduced tax rate. This is appropriate because such companies generally could not previously avail themselves to a 2004 provision to encourage investment of foreign earnings in the U.S.

ASRA also contains a strong jobs provision. In order to preserve the tax benefits provided under ASRA, companies must maintain their current employment levels. If they fail to do so, they will be subject to a significant tax penalty. Specifically, there would be a $25,000 additional income inclusion for each employee by which the taxpayer's average employment during the two-year period from and including the calendar month of the first shipping income repatriation is less than the average employment during the two-year period prior to that same month of first repatriation.

ASRA'S IMPACT: INVESTMENT, ECONOMIC ACTIVITY, JOBS, AND SECURITY

As Congress considers legislation to address unemployment and stimulate the American economy, it should consider the merits of ASRA. Enacting ASRA would allow, and incentivize, these companies to bring funds that are currently invested abroad home and reinvest them in the U.S. shipping industry. ASRA would spur job growth in the U.S. by creating a broad and diverse range of well-paying employment opportunities for American workers, both in the short- and long-term. As a result, ASRA is broadly supported by American maritime labor, U.S. shipyards, and U.S. shipping companies.

Enactment of ASRA would stimulate investment in the U.S. shipping industry, leading to the creation of well-paying jobs as construction and repair activity in U.S. shipyards increased. The magnitude of the stimulative economic effect of building ships in the U.S. is significant - a 2002 study performed for the Shipbuilders Council of America found that 3.7 jobs were created elsewhere in the economy for every direct shipyard job. Moreover, as a result of tax provisions in the 2004 Jobs Act, OSG commissioned the construction of 10 new tankers at a U.S. shipyard, the largest commercial shipbuilding project in a U.S. shipyard since World War II. A study performed on this project found that the new shipbuilding activity for these 10 tankers would increase average annual employment in the region where the shipyard was located by 1,217 jobs and nationally by 2,902 jobs during the period of construction. OSG later increased its commitment with orders for 2 additional tankers and 2 additional tank barge vessels, resulting in even more employment growth and economic activity.

Once in operation, these ships will generate American employment throughout the life of the vessel, which is estimated to be at least 25 years. Ships operating in the domestic Jones Act trades must be manned by Americans, built in a U.S. shipyard, and owned by U.S.-citizen companies. As such, by encouraging American companies to expand their Jones Act operations, ASRA would create and sustain thousands of jobs for Americans during the operating life of the new vessels. These include well-paying jobs in the seagoing and shore side trades, as well as in the shipyards that will maintain the vessels during their economic life. In fact, it is estimated that the 10 new tankers constructed because of the 2004 Jobs Act will increase average annual shore side and seagoing employment directly related to the vessel's operations by 1,313 and increase average labor compensation by $1.2 billion over the period of 2007 to 2020.

Investment in the U.S. shipping industry would have an economic "multiplier" effect, spurring job growth in affiliated businesses. In addition to the direct employment effect of ship construction and operations, studies indicate that investment in the U.S. shipping industry would have the indirect effect of increasing demand placed on suppliers through the supply chain and the induced effect of additional spending on goods and services resulting from increased household incomes.

Additionally, ASRA would enhance U.S. national security interests by supporting shipyards that are vital to our defense industrial base by developing new U.S.-flag tanker capacity to transport our nation's energy products, and by providing the DOD with critical assets – manpower and ships – necessary to help sustain military sealift.

CONCLUSION

OSG greatly appreciates the opportunity to submit this statement. As Congress considers ways to increase investment in the U.S., ASRA presents an opening to create thousands of American seagoing and shore side jobs and stimulate critical investments into American shipping companies that help sustain our economic and national security. We are happy to be a resource to Congress, the Committee, and the Subcommittee and we look forward to our continued work together on these issues.