

# TAX REFORM: TAX HAVENS, BASE EROSION AND PROFIT-SHIFTING

---

---

## HEARING BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED THIRTEENTH CONGRESS FIRST SESSION

—————  
JUNE 13, 2013  
—————

**Serial No. 113-FC09**

—————

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PUBLISHING OFFICE

21-122

WASHINGTON : 2017

---

For sale by the Superintendent of Documents, U.S. Government Publishing Office  
Internet: [bookstore.gpo.gov](http://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

DAVE CAMP, Michigan, *Chairman*

SAM JOHNSON, Texas	SANDER M. LEVIN, Michigan
KEVIN BRADY, Texas	CHARLES B. RANGEL, New York
PAUL RYAN, Wisconsin	JIM MCDERMOTT, Washington
DEVIN NUNES, California	JOHN LEWIS, Georgia
PATRICK J. TIBERI, Ohio	RICHARD E. NEAL, Massachusetts
DAVID G. REICHERT, Washington	XAVIER BECERRA, California
CHARLES W. BOUSTANY, JR., Louisiana	LLOYD DOGGETT, Texas
PETER J. ROSKAM, Illinois	MIKE THOMPSON, California
JIM GERLACH, Pennsylvania	JOHN B. LARSON, Connecticut
TOM PRICE, Georgia	EARL BLUMENAUER, Oregon
VERN BUCHANAN, Florida	RON KIND, Wisconsin
ADRIAN SMITH, Nebraska	BILL PASCRELL, JR., New Jersey
AARON SCHOCK, Illinois	JOSEPH CROWLEY, New York
LYNN JENKINS, Kansas	ALLYSON SCHWARTZ, Pennsylvania
ERIK PAULSEN, Minnesota	DANNY DAVIS, Illinois
KENNY MARCHANT, Texas	LINDA SANCHEZ, California
DIANE BLACK, Tennessee	
TOM REED, New York	
TODD YOUNG, Indiana	
MIKE KELLY, Pennsylvania	
TIM GRIFFIN, Arkansas	
JIM RENACCI, Ohio	

JENNIFER M. SAFAVIAN, *Staff Director and General Counsel*  
JANICE MAYS, *Minority Chief Counsel*

## CONTENTS

---

	Page
Advisory of June 13, 2013 announcing the hearing .....	2
WITNESSES	
Mr. Edward Kleinbard, Professor of Law, University of Southern California Gould School of Law .....	16
Mr. Paul Oosterhuis, Partner, Skadden Arps Slate Meager & Flom LLP .....	38
Mr. Pascal Saint-Amans, Director, Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development (OECD) .....	7



**TAX REFORM: TAX HAVENS, BASE EROSION  
AND PROFIT-SHIFTING**

---

**THURSDAY, JUNE 13, 2013**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
*Washington, DC.*

The Committee met, pursuant to call, at 10 a.m., in Room 1100,  
Longworth House Office Building, the Honorable Dave Camp  
[Chairman of the Committee] presiding.  
[The advisory announcing the hearing follows:]

# ***ADVISORY***

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE  
June 6, 2013  
No. FC-09

CONTACT: (202) 225-3625

## **Camp Announces Hearing on Tax Reform: Tax Havens, Base Erosion and Profit-Shifting**

Congressman Dave Camp (R-MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on U.S. and foreign multinational corporations' use of tax havens (low- and no-tax jurisdictions) to avoid tax and shift profits outside the United States and erode the U.S. tax base – as part of the Committee's continued work on comprehensive tax reform. **The hearing will take place on Thursday, June 13, 2013, in Room 1100 of the Longworth House Office Building, beginning 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:**

Recent press attention has focused on a number of sophisticated tax planning strategies used by worldwide corporate groups to shift taxable income out of the United States and other relatively high-tax jurisdictions, and into low- or no-tax jurisdictions. These strategies include transactions such as migrating highly mobile assets (e.g., intangible property) to tax havens, financing exempt foreign income with deductible U.S. costs, and reincorporating in a low- or no-tax jurisdiction. In many cases, these transactions shift profits outside of the United States, thus eroding the U.S. tax base and costing the Treasury large sums of tax revenue. In other cases, these strategies merely shift profits from a high-tax foreign jurisdiction to a low-tax foreign jurisdiction, thus having little or no net impact on U.S. tax revenues.

The Organisation for Economic Co-operation and Development (OECD), an international organization of 34 developed countries, recently has undertaken a project on Base Erosion and Profit Shifting (BEPS) out of a concern that current transfer pricing rules used by Member States allow for the allocation of taxable income to locations different from those where the actual business activity takes place. On May 29, 2013, at the Meeting of the OECD Council at Ministerial Level, the ministers and representatives of national governments in attendance issued a "Declaration on Base Erosion and Profit Shifting." The signatories declared that BEPS "constitutes a serious risk to tax revenues, tax sovereignty and the trust in the integrity of tax

systems of all countries that may have a negative impact on investment, services and competition, and thus on growth and employment globally.” They also welcomed the recently released OECD BEPS report and the OECD’s intent to provide a Comprehensive Action Plan to combat BEPS to the G20 finance ministers in July 2013.

**In announcing this hearing, Chairman Camp said, “The use of tax havens as part of corporate tax avoidance strategies narrows the U.S. tax base and requires other taxpayers to pay higher rates on both domestic and overseas income. There is widespread agreement amongst academics, economists and lawmakers that these practices are both unfair to taxpayers who aren’t able to engage in these strategies and harmful to the U.S. economy. The Committee’s discussion draft on international tax reform included options to combat base erosion as part of a larger effort to broaden the tax base, lower tax rates and move towards a more modernized and competitive system of international taxation. As the Committee works to design tax reform policies that make our broken tax code simpler, fairer and more conducive to creating jobs and increasing wages, understanding the impact of these practices will result in more informed policymaking.”**

**FOCUS OF THE HEARING:**

The hearing will examine different tax planning strategies used by multinational corporations to shift income out of the United States and into low-tax jurisdictions. The hearing also will consider when profit shifting truly is eroding the U.S. tax base and when companies are shifting profits amongst different foreign jurisdictions without affecting U.S. tax collections.

**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, June 27, 2013**. 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 CAMP. Good morning. The committee will come to order. Thank you all for being here.

On October 26, 2011, as part of its overall approach to comprehensive tax reform that lowers rates and broadens the base, this committee released a discussion draft aimed at modernizing our outdated international tax rules. The draft included a structure that would allow the U.S. to move from a worldwide taxation system to a participation exemption system similar to that used by almost all of our major trading partners.

In the interest of transparency, we made a specific request. We actively sought feedback from stakeholders, taxpayers, practitioners, economists, and members of the general public in how to improve the draft proposal. Since then we have heard from a wide range of practitioners and worldwide American companies. Nearly all have offered a universal observation: Having the highest corporate rate in the developed world, along with an outdated international tax system, is a barrier to success that leaves our country falling further behind our foreign competitors.

Academics and economists agreed and also cautioned that any solution to these challenges must protect against erosion of the U.S. tax base through the shifting of profits to low-tax jurisdictions. Their concern is not without merit. Oftentimes multinational businesses reduce their tax liability by separating the jurisdiction in which income is booked for tax purposes from the jurisdiction in which the economic activity occurs. The result of these practices is erosion of the tax base in a jurisdiction where the activity takes place.

We have all heard and read about these practices. As we will hear today, the commentary on these practices varies greatly. As policymakers engaged in the tax reform debate, it is clear that



there is no perfect system for taxing corporate income. But it is also important to bear in mind that these activities are fundamentally the consequences of bad laws and not necessarily bad companies.

In my mind, the fact that the current Tax Code allows companies to achieve these tax results strengthens the case for comprehensive tax reform. Whether a country has a hybrid system similar to the current United States' worldwide system or a dividend exemption system like that of our major trading partners, it is important to develop strong base erosion rules that protect against aggressive transfer pricing, migration of intangible property overseas, and foreign earning stripping.

Let me just say that it is important to remember that the most effective anti-base erosion rule is a lower corporate tax rate. But unfortunately, while a lower rate is necessary, the rate alone is not sufficient.

Mindful of the need to develop meaningful protections of the U.S. tax base, the international tax reform discussion draft included three options to mitigate U.S. base erosion. Although the merits of each option remain open for debate, option C, the carrot and stick proposal, received, and continues to receive, the most support from the business community, and our close work with the staff of the Joint Committee on Taxation leads us to believe it is an effective safeguard.

Under option C, all foreign income attributable to intangibles, whether or not owned by the U.S. parent or foreign subsidiary, would be taxed by the United States at a substantially lower rate of 15 percent, minus any credits for foreign taxes paid on the same income. This approach provides a deduction for income related to intangibles kept in the United States—the carrot—and an immediate inclusion for income related to intangibles held abroad—the stick. In other words, companies would feel less pressure to shift income to low-tax jurisdictions because that income would be taxed at the same rate, whether it is earned in the United States or Bermuda.

The results of this approach would be that moving intangibles to tax havens would have little or no appeal, since the income earned from those intangibles obviously would be taxed at the same rate, regardless of location. In fact, some companies have said that intangibles which have already been moved to tax havens under our current system could actually be moved back to the United States because there would not be any tax advantage to owning them abroad.

The U.S. is not the only country concerned about base erosion. We will hear testimony today from the OECD about its base erosion and profit shifting report. As noted in the report, every jurisdiction is free to set up its corporate tax system as it chooses; however, the OECD's attention to this issue underscores that concerns about base erosion exist globally and must be considered as solutions are developed that are unique to each country's tax system.

As I said at the outset, there is no perfect solution, and all systems have problems with base erosion. Our task is to develop a system that is more in tune with the global marketplace, and that will allow domestic companies to prosper while simultaneously pro-

tecting the U.S. tax base. Comprehensive tax reform that includes a more modernized system of international taxation, coupled with a lower rate, can create the climate necessary for those companies to prosper, invest and hire here at home.

I will now recognize Ranking Member Levin for his opening statement.

Mr. LEVIN. Thank you very much.

Good morning, and thank all of you, the three of you, for coming to testify today on this important subject.

I am glad we are looking at the issue of international taxation today. I believe it highlights the need for tax reform to be about so much more than just lower rates or labels like “worldwide” and “territorial.” We live in a global economy. That is not going to change. There have been and will continue to be major benefits from globalization, which has occurred more rapidly in recent decades than in all previous ones combined. It has been furthered by dramatic new technologies that quickly spread beyond national borders.

But globalization often can spread its benefits in very uneven and sometimes harmful patterns. Indeed, it presents increasing challenges to tax policies. And that is why we are here today, that is what we must confront, and it is the crux of what we are discussing, as I said, here today.

Entities that truly have a home base in our Nation and experienced many benefits and advantages as a result are using their presence, or their pro forma presence, in other places to lower their tax bills. Often the effect is so dramatic that it is difficult for the average taxpayer to believe that such tax avoidance is legal. The fact that it is, and is widespread, only highlights the urgent need to confront it.

That truth was on vivid display last month when the Senate Permanent Subcommittee on Investigations revealed the complex structures and intergroup transactions that some multinational corporations employ in order to shift profits offshore in an effort to avoid U.S. taxes. The investigation illustrated how Apple’s international tax planning techniques have enabled that tax giant to dramatically lower its tax bill. One example showed how an Irish entity, established by Apple, Inc., received tens of billions of dollars of income with no tax residence, and as a result paid no taxes. Other major corporations like Microsoft, HP, and Google have also been shown to use legal tax-avoidance techniques to shift income overseas to lower their U.S. tax liability.

But as we will hear today, the problem is not isolated to the U.S. Jurisdictions throughout the world, particularly European Union member nations, are realizing that companies are engaging in complicated structures that often have no economic value or substance simply to avoid taxes. The response is anger from businesses that compete to citizens who are facing deep cuts in important government programs.

The challenge of ending massive tax avoidance must be at the forefront of any tax-reform effort worth its salt. I believe that will be confirmed by today’s testimony. No country can compete with a zero percent tax rate. Any tax reform must end the use of loopholes

and base-erosion techniques, including addressing how to curtail the shifting of jobs and profits offshore.

Our current Tax Code creates incentives for multinational enterprises to shift money overseas, and with that money goes jobs. The days of so-called stateless income and double nontaxation must end. We cannot participate in a global race to the bottom that results in taxing jurisdictions being the big losers. Our Tax Code must not only promote American competitiveness at home and abroad, it must also promote domestic job creation that strengthens economic security for workers and businesses here in the U.S. Reform of our international tax rules cannot be done on the backs of small businesses, domestic companies, and individual taxpayers.

So all of us on this side and, I think, throughout the committee look forward to hearing from the witnesses and learning more about your ideas to reform this area of the law. All of us appreciate the time and resources you have spent to help inform this committee on this complex and sometimes opaque area of the tax law. This discussion is an important step in reforming our international tax system.

Thank you.

Chairman CAMP. Thank you, Mr. Levin.

Now it is my pleasure to welcome our panel of experts, all of whom bring a wealth of experience from a variety of perspectives. Their experience and insights will be very helpful as our committee considers the impact of Federal tax reform on tax havens, base erosion, and profit shifting.

First, I would like to welcome Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development based in Paris, France. Second, we will hear from Edward Kleinbard, professor of law at the University of Southern California Gould School of Law in Los Angeles, California, and a former chief of staff at the Joint Committee on Taxation. Welcome back to the committee, Professor Kleinbard. And finally, we will hear from Paul Oosterhuis, a partner at Skadden Arps Slate Meager & Flom here in Washington, D.C., and a widely recognized authority on international tax issues. We welcome you back to the committee as well.

Thank you all, again, for being with us today. The committee has received each of your written statements, and they will be made a part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks.

Mr. Saint-Amans, we will begin with you. You are recognized for 5 minutes.

**STATEMENT OF MR. PASCAL SAINT-AMANS, DIRECTOR, CENTRE FOR TAX POLICY AND ADMINISTRATION, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)**

Mr. SAINT-AMANS. Thank you, Chairman. It is an honor to testify here today as the Director for Tax Policy at the OECD, which is an international organization—the U.S. is a permanent member of this organization—which includes 34 members overall.

Tax work at the OECD focuses primarily on eliminating double taxation. As you know, when you have cross-border investments,

they can be taxed at source, in the country where the operations are taking place, but also at residence, where the headquarters of the international company is based. As a result you may have tax at source and at residence. And this is no good for cross-border investments, which all countries need in a free trade environment to foster growth and to foster jobs. And for the case, we have been working on eliminating double taxation by providing a Model Tax Convention on which countries draw when they negotiate bilateral treaties, as the U.S. is doing.

We also do some economic analysis. And we recently issued reports, trying to see what are the merits or the lack of merits of different taxes. And the corporate income tax is not a progrowth tax. What has been recommended from this analysis is that lowering the rates and broadening the base would be more favorable to growth than having very high rates. We must recognize that the U.S. now—after Japan's recent move to lower the rate—the U.S. has the highest rate for corporate income tax in the OECD, which is 35 percent, not taking into account the local rates, the State rates.

What has happened over the past few years, I would say 3 to 4 years, is a growing concern in all OECD countries—and this goes beyond OECD countries to include what we call the BRISC—Brazil, Russia, India, South Africa, China, and some others—about what we now call base erosion and profit shifting. That is why the OECD was asked by its member countries to launch this project on BEPS to put an end to what countries identify as double nontaxation.

We have moved from removing double taxation to an environment where the international rules, articulated with domestic legislations, might result in growing double nontaxation, as, Chairman, you have just explained. The OECD has been asked to look at the reasons why we have come to that situation.

These concerns, of course, have been growing because of the crisis—the financial crisis turning into a fiscal crisis, turning into a political crisis, in some countries a social crisis—with the growing awareness that there is an issue with domestic companies not exposed to international transactions paying an effective tax rate which is close to the statutory tax rate, while some other companies exposed to international transactions can reduce their effective tax burden to very low rates. I mean, a 3, 4, 5 percent effective tax rate for a number of companies. And this is a global issue. It is not a U.S. issue as it is portrayed by some in Europe, for instance; it is something that you find in all countries, including in European countries.

The OECD project is about trying to put all the countries together to try to identify what type of solutions can be brought to this global issue. The solutions are not about any kind of harmonization, because the world is made of tax sovereignties, and every country decides on its own sovereignty. But countries cannot ignore the spillover effects of what they are doing, or a single country cannot address the whole issue. Otherwise it would put its own businesses at a competitive disadvantage. I think that can be the value added of the OECD, to make sure that all countries know what the others are doing and may benefit from best practices. And this is

why we have issued this report, which is annexed to my written testimony, which is a report on base erosion and profit shifting, which was issued in February.

Since February, we have developed an action plan, which will be ready and published in July and then reported to the G20 Finance Ministers on the 20th of July when they meet. And in the action plan we consider a number of areas where actions could be taken, meaning developing some guidelines or some models, as the OECD does, letting, of course, the countries decide whether they want to draw on that or not. Within the actions there will be something on controlled foreign companies, which is what you are trying to address in the draft.

So I will be very happy to answer any questions you may have on this action plan. Thank you, Chairman.

Chairman CAMP. Thank you.

[The prepared statement of Mr. Saint-Amans follows:]

**Testimony of Pascal Saint-Amans**  
**Director, Centre for Tax Policy and Administration,**  
**Organisation for Economic Co-operation and Development (OECD)**  
**Before the U.S. House Ways and Means Committee**  
**Hearing on Tax Reform: Tax Havens, Base Erosion and Profit Shifting**  
June 13, 2013

Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for inviting me to testify today regarding the work of the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS).

The OECD is an international organization with 34 member countries and six key partners (Brazil, China, India, Indonesia, Russia, and South Africa). The mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyse and compare data to predict future trends. We establish international consensus-based standards on topics ranging from tax to the safety of chemicals.

We work with business, through the Business and Industry Advisory Committee to the OECD, and with labour, through the Trade Union Advisory Committee. We have active contacts as well with other civil society organisations. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the wellbeing of all citizens.

#### **OECD's Work on Base Erosion and Profit Shifting**

In the area of tax, the core work of the OECD has been to develop, on the basis of international consensus, common standards to eliminate double taxation for cross border investments, specifically the Model Tax Convention (which serves as the basis for over 3,000 bilateral tax treaties) and the Transfer Pricing Guidelines (which provide common standards for allocating income among members of a group of affiliated companies). These instruments have been critical in promoting economic growth by removing barriers to cross-border investment, most importantly by preventing double taxation and by providing the certainty and stability necessary for international investment.

#### **The OECD BEPS Project**

While the core of the OECD work in the tax area remains the prevention of double taxation, there is growing concern in OECD member countries and in G20 countries about the issue of double non-taxation due to BEPS. Stated simply, BEPS arises because under the existing rules multinational enterprises (MNEs) are often able to artificially separate their taxable income from the jurisdictions in which their income-producing activities occur. This can result in income going untaxed anywhere, and significantly reduces the corporate income tax paid by MNEs in the jurisdictions where they operate. BEPS thus impacts countries around the globe, and it has become a significant political issue in OECD and non-OECD countries alike.

While there clearly is a tax compliance aspect, as shown by a number of high profile cases, there is a more fundamental policy issue: the common international tax standards may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies.

The ability of some taxpayers to reduce their taxes by separating their income from the jurisdictions in which they operate creates an unlevel playing field, which undermines competition and economic efficiency. This is because some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from BEPS opportunities and therefore receive unintended competitive advantages compared with enterprises that operate mostly at the domestic level. This, in turn, leads to an inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return. Moreover, such a result affects the perceived fairness of the tax system as a whole, which can undermine voluntary compliance by all taxpayers.

### **The BEPS Report**

The debate over BEPS, which was initiated at the OECD last year, has become an issue on the agenda of many OECD and non-OECD countries. The G20 leaders meeting in Mexico on June 18-19, 2012, explicitly referred to “the need to prevent base erosion and profit shifting” in their final Declaration. This message was reiterated at the G20 finance ministers meeting of November 5-6, 2012, the final communiqué of which states: “We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting,” in February 2013.

Following the call of the G20, the OECD published its report, *Addressing Base Erosion and Profit Shifting*, in February 2013, a copy of which is annexed to this testimony. The report provides results of an in-depth analysis of BEPS to identify, based on the available data and information, the problems and the different factors that cause them.

As noted in the report, every jurisdiction is free to set up its corporate tax system as it chooses. States have the sovereignty to implement tax measures that raise revenues to pay for the expenditures they deem necessary. An important challenge relates to the need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment nor that it distorts competition and investment within each country by disadvantaging domestic players. In a globalised world where economies are increasingly integrated, domestic tax systems designed in isolation are often not aligned with each other, thus creating room for mismatches. These mismatches may result in double taxation and may also result in double non-taxation. In other words, these mismatches may in effect make income disappear for tax purposes. This leads to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue.

Considering how tax systems interact with each other is therefore relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation. Further, double tax treaties, which are bilateral tools that countries use to co-ordinate the exercise of their respective taxing rights, may also create opportunities for taxpayers to obtain tax advantages in the form of lower or no taxation at source and/or lower or no taxation in the state of residence of the taxpayer.

The report notes that, while the specific goals vary among MNEs, broadly speaking BEPS focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. The report identifies key pressure areas giving rise to opportunities for BEPS:



- International mismatches in entity and instrument characterisation including, hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions;
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- The effectiveness of anti-avoidance measures, in particular general anti-avoidance rules (GAARs), CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse; and
- The availability of harmful preferential regimes.

The report was discussed at the February 2013 Moscow G20 meeting of finance ministers, who expressed strong support for the work done and urged the development of a comprehensive action plan to be presented at the G20 meeting in July. The action plan will provide comprehensive, coordinated strategies for countries concerned with BEPS, while at the same time ensuring a certain and predictable environment for business.

#### **Development of the Action Plan**

The action plan will provide a sense of direction on actions that will be taken to address BEPS. Specifically, the action plan will call for the development of tools that countries can use to address BEPS. Because BEPS strategies often rely on the interaction of countries' different systems, these tools will have to address the gaps and frictions that arise from the interface of these different systems.

For example, the report calls for the development of tools to address hybrid mismatch arrangements – structures or transactions that take advantage of the different treatment of entities or instruments by different countries to achieve a deduction with no corresponding inclusion, or multiple deductions for the same economic expense. Work in this area is expected to examine the existing rules that countries have developed to address these issues, and provide recommendations regarding the design of such rules.

Similarly, a key concern of many countries is the use of excess interest expense to erode the tax base. While many countries have enacted limitations on the deductibility of interest expense, the different approaches taken can create the opportunity for countries to arbitrage the different rules, and in some cases may result in economic double taxation to the extent that real economic costs are denied deduction in all jurisdictions. The report calls for the action plan to develop rules in this area, and the work is expected to examine the existing approaches countries have taken and to develop best practices.

A second key element is to better align taxation and the substance of taxpayers' value creating activities. The international standards, including the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines, are generally based on the assumption of a

bilateral relationship between two jurisdictions with relatively comparable tax systems. Today's environment, by contrast, is characterized by globally integrated business models, with investments often channelled through third countries.

The international standards must be updated to reflect this new reality, and the report thus calls for updates to treaty provisions in this regard. Similarly, the report calls for improvements to the transfer pricing rules to address, in particular, the use of intangibles and the shifting of risk to separate taxable income from value creation.

Finally, in order for changes to the rules and international standards to be effective, greater transparency will be needed. This includes the provision of better information by taxpayers to tax administrations and more effective cooperation among tax administrations. For example, many countries, including the United States, have rules that require disclosure of certain types of aggressive transactions, and work is expected to develop recommendations regarding the design of such rules. In addition, the documentation that companies currently provide regarding their transfer pricing strategies can be very extensive and burdensome, both on taxpayers and on tax administrations, and in many cases may not be very useful to provide an overall picture of the relevant transfer pricing risks. Work is expected to develop more effective (and preferably, simplified) forms of transfer pricing documentation.

The action plan will also consider the best way to implement in a timely fashion the measures governments can agree upon. If treaty changes are required, solutions for a quick implementation of these changes should be examined and proposed as well. At the same time that the OECD steps up its efforts to address double non-taxation it must also continue its work to eliminate double taxation. In this respect, the report suggests that a comprehensive approach should also consider possible improvements to eliminate double taxation, such as increased efficiency of mutual agreement procedures and arbitration provisions.

It is important to note that the work of the OECD is done entirely by consensus. That is, measures cannot be adopted without the consensus of all member countries. Moreover, the results of the work on BEPS generally will be tools that countries can use to address BEPS. Each country ultimately must make its own tax policy choices. Countries have recognized, however, that opportunities for BEPS fundamentally arise from the interaction of gaps in the interaction of different countries' systems, and that no one country can by itself completely address BEPS. In addition, countries have recognized that uncoordinated, unilateral action to exert taxing rights over cross-border activity likely will result in double or multiple taxation of cross-border investment, leading to increased disputes among governments and harming economic growth at a time when the world can least afford it. The OECD work thus represents a critical forum for countries to collaborate to establish consensus-based international standards to address this common issue while also providing business the certainty and predictability needed for international investment and growth.

#### **Next Steps**

The development of the BEPS action plan is being driven by OECD member countries, in consultation with key non-OECD countries and other stakeholders, including the business community and civil society. Businesses generally recognize the serious risks that would come from uncoordinated action, and have expressed their support for work on BEPS to be done multilaterally, and by the OECD in particular, given the OECD's existing expertise and consensus-driven process.

After the action plan has been approved, it is expected that work on the actions will generally be complete within two years, though some actions may be developed more quickly, and some may take additional time. We believe this work will provide countries with the tools they need to address this pressing issue.

While the work on BEPS is a key issue in many countries, it should also be viewed in the context of the broader tax policy choices that each country makes. In this context, the OECD has long recommended that countries reduce the distortive impacts of their tax regimes, and thus improve economic growth, by broadening the tax base (of which measures to address BEPS can be an important part) and lowering the rate. We hope that our work, including the work on BEPS, can be helpful in the ongoing tax policy reform discussions in the United States.

I would like to thank the Committee for the opportunity to provide testimony on this important work, and I look forward to answering your questions.



Chairman CAMP. Second, we will hear from Edward Kleinbard, professor of law at the University of Southern California. We certainly look forward to hearing your testimony, Mr. Kleinbard. You have 5 minutes.

**STATEMENT OF MR. EDWARD KLEINBARD, PROFESSOR OF LAW, UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF LAW**

Mr. KLEINBARD. Thank you.

Chairman Camp, Ranking Member Levin, distinguished Members, multinational firms today engage in large-scale base erosion and profit shifting, what I call the generation of stateless income. This committee's international discussion draft was sensitive to the problems posed by stateless income strategies, and this hearing demonstrates your interest in protecting revenues from the spread of what might be called unprotected territoriality.

But the problems have been underestimated, and stronger anti-abuse measures are required. For example, one recent study found that 54 percent of U.S. firms' foreign income is taxed at effective rates below 15 percent, and 37 percent of foreign income enjoys tax rates below 5 percent.

My current research project, for example, looks at Starbucks, a classic bricks-and-mortar retail operation that deals directly with customers at thousands of locations around the world. Yet it appears that Starbucks has successfully reduced its foreign tax liabilities to surprisingly low levels. To put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can do so.

The recent Senate PSI hearing focusing on Apple raises similar concerns. To me, the most remarkable aspect of the hearing was the baldness of Apple's tax planning. In effect, in 1980, Apple created a shell company in Ireland, capitalized it, and executed a contract on behalf of itself and this subsidiary in which the subsidiary returned to Apple some of the capital ceded to it a moment before and thereby purportedly acquired ownership in all of Apple's intangible assets outside the Americas. My description obviously simplifies the facts, but captures the essence of the story.

Now, no one likes the current international tax rules, but the debates about a replacement have been marred by some recurring myths and misunderstandings. I wish to address just one of these. Intuitively it seems sensible to argue that when our multinationals employ stateless income technologies to minimize their foreign tax liabilities, we should cheer rather than criticize, but this is false. In fact, that apparently foreign income often is U.S. income traveling incognito. What's more, the stream of tax-free foreign income encourages U.S. firms to engage in tax arbitrage by leaving all their global interest expense in the U.S. parent, where it reduces wholly domestic taxable income.

Further, the prospect of stateless income distorts investment decisions by offering U.S. firms the possibility of realizing supersized returns on their foreign investments; what I call tax rents. And finally, promoting our national champions to avoid other countries' taxes leads to the mirror-image response from those other countries and a "beggar thy neighbor" race to the bottom, where multi-

national firms are the only winners and every taxing jurisdiction the loser.

While I applaud the committee's inclusion of antiabuse rules in its discussion draft, I am concerned that none of them, including option C, will work very well or be administrable. What then should we do? Many recommend a territorial system with some form of antiabuse constraints, what we now call the hybrid system, but I believe there is a simpler alternative that is more resistant to tax gaming; that, in fact, is competitive; and it makes economic sense: genuine worldwide tax consolidation, just as we do for financial statement purposes, combined with a corporate tax rate squarely in the middle of the pack, let us say 25 percent.

This idea is less wacky than you might think. The economic effects of worldwide consolidation are basically the same as the territorial tax, with a 25 percent worldwide minimum tax as an antiabuse measure. True worldwide consolidation is competitive with the tax environments that foreign and domestic firms face in the countries in which they actually do business. By contrast, current law or, alternatively, unprotected territoriality heavily subsidizes foreign investment at the expense of our own domestic economy.

Finally, every U.S. multinational firm should be required immediately to publish a worldwide disclosure matrix of its actual tax burdens by jurisdiction. Tax transparency rules are not a substitute for substantive international tax reform, but they would enable tax authorities to identify patterns of possibly inappropriate income shifting, thereby making better use of limited audit resources. A transparency principle also would awaken the public to the massive amounts of international tax avoidance today known only to specialists.

Thank you, Mr. Chairman.

Chairman CAMP. Well, thank you very much, Mr. Kleinbard.

[The prepared statement of Mr. Kleinbard follows:]

**TESTIMONY OF PROF. EDWARD D. KLEINBARD**

**HEARING TITLED**

**“TAX REFORM: TAX HAVENS, BASE EROSION AND PROFIT-SHIFTING”**

**U.S House of Representatives Committee on Ways and Means**

**June 13, 2013**

Chairman Camp, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard; I am a Professor of Law at the University of Southern California’s Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress’s Joint Committee on Taxation.

**I. SUMMARY OF TESTIMONY.**

- U.S. multinational firms, as well as multinational firms resident in other countries, today engage in large-scale base erosion and profit-shifting – what in my academic papers I have labeled the generation of “stateless income.”
- The existence of proposed anti-abuse rules in this Committee’s international tax reform Discussion Draft, and this hearing itself, stand as testament to the Committee’s insistence on precluding what I think of as “unprotected territoriality.” But recent developments suggest that the Committee, and fiscal authorities around the world, have underestimated the magnitude of the problem, and that stronger anti-abuse measures are urgently required.
- For example, working directly with tax return data, Harry Grubert and Rosanne Altshuler recently found that foreign subsidiaries of U.S. firms today enjoy effective tax rates of *less than five percent* on nearly 37 percent of their total income. *Fifty-four percent* of U.S. controlled foreign corporations’ total income is taxed at effective rates of 15 percent or lower.

- My own new paper looks at Starbucks Corporation, a classic bricks and mortar retail business model, with direct customer interactions in thousands of “high street” locations in high-tax countries around the world. Nonetheless, it appears that Starbucks has successfully reduced its foreign tax liabilities to surprisingly low levels. To put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can.
- The recent Senate PSI hearing focusing on Apple Inc. also is consistent with the seriousness of the situation. What was most remarkable was the baldness of Apple’s tax planning. The entirety of the business arrangements that explain why Apple paid virtually no tax anywhere in the world on tens of billions of dollars of income attributable to U.S. R&D boils down to this: in 1980 Apple created a shell company subsidiary in Ireland, capitalized it, and entered into a special kind of contract with this shell company (a “cost sharing agreement”), in which the shell company returned to Apple some of the capital seeded to it by Apple, thereby first purportedly acquiring ownership in all of Apple’s intangible assets outside the Americas. This description is a bit simplified, but in essence, that is the entirety of the story.
- The Apple hearing, press articles and comments filed with this Committee in response to its Discussion Draft all represent a healthy and widely-shared interest in improving the current system, even if proposed solutions vary. But current debates often are marred by the injection into the arguments of some recurring myths and misunderstandings. I wish to address three of these.
- Myth I: We Should Cheer When Our Companies Avoid Foreign Taxes. It is intuitively appealing to argue that when “our” multinationals employ stateless income technologies to minimize their foreign tax liabilities, the outcome is something we should cheer rather than criticize. But this is false. That apparently foreign income often in fact is U.S. income traveling incognito. The stream of tax-free foreign income encourages U.S. firms to engage in tax arbitrage, by leaving all their global interest expense in the U.S. parent, where it erodes the domestic tax base (by reducing wholly domestic taxable income). The prospect of stateless

income distorts investment decisions, by offering U.S. firms the possibility of supersized returns (what I call “tax rents”) on foreign investments. And finally, promoting our national champions to avoid the tax systems of other countries leads to the mirror image response from them, and a beggar-thy-neighbor race to the bottom, where multinational firms are the winners and every taxing jurisdiction the loser.

- Myth II: Firms’ Money is Trapped Abroad, to Our Great Detriment. U.S. firms today have nearly \$2 trillion in offshore so-called “permanently reinvested earnings.” Some of that \$2 trillion is invested in real businesses around the world, but a large fraction is held in cash. It is intuitively appealing to argue that all of this “trapped” cash is lying fallow, as if it were buried in a backyard in Zug. But again this is false. The money in fact already is at work in the United States, in the form of loans to the U.S. government or U.S. businesses. What is more, as I explain in my detailed comments, firms like Apple have demonstrated how easy it is to engage in a virtual repatriation of offshore cash on a tax-free basis, and use that virtual transaction to fund current stock buy-backs.
- Myth III: Everything That U.S. Firms Do is “Legal.” U.S. multinational firms have not done anything remotely illegal in their stateless income planning. But observers then wrongly conclude that everything that U.S. firms have done in this area must therefore be “legal.” This is a meaningless phrase in this context. Every large U.S. firm is audited by the Internal Revenue Service on a continuous basis. Firms take tax return positions that they expect to be challenged, they establish accounting reserves for uncertain tax positions, and they often settle tax disputes (most commonly at the administrative level) by paying additional tax. The question is not whether a particular firm’s stateless income planning is “legal,” but rather whether that planning is inappropriately aggressive. By being aggressive, some large multinational firms achieve tax results that they would not obtain if the energies available to the two sides of the argument were more evenly matched. This in turn has important repercussions for tax system design. It means that a complex and highly fact-driven international corporate tax system



invariably will lead to lower tax revenues than might be expected under more neutral terms of engagement, and it means that the corporate tax system in turn will have a negative spillover into personal tax collections, through a degradation of individuals' confidence in the fairness of the tax system.

- What then should we do? There is something of a consensus around the idea of a territorial system with anti-abuse constraints (or a "hybrid" system, as some prefer), but I respectfully submit that there is a far simpler alternative that is more resistant to tax gaming, that is "competitive," and that is economically defensible: genuine worldwide tax consolidation, combined with a corporate tax rate squarely in the middle of the pack of peer countries' rates – say 25 percent. Financial accounting norms of course require worldwide consolidation in presenting the results of a multinational firm's activities. The resulting system is simple and, more important, highly resistant to tax gaming, because there are no positive returns to base erosion or profit shifting. What is more, my proposed system is "competitive," in proper sense of being competitive with the tax environment that foreign domestic firms actually face in the country in which they operate, rather than a system that, like current law, or like unprotected territoriality, heavily subsidizes foreign investment, at the expense of our own domestic economy. If it helps, one can visualize my proposal as a territorial tax system with a 25 percent worldwide (not per country) minimum tax – the economic effects are the same.
- Finally, without regard to the fate of tax reform legislation, I urge the Committee to work with other Committees of the House to put onto a fast track legislation requiring every U.S. multinational firm to publish a worldwide disclosure matrix of its actual tax burdens by jurisdiction. Tax transparency rules are not a substitute for substantive international tax reform, but they would enable tax authorities to identify possible patterns of inappropriate income shifting, thereby making better use of limited audit resources. A transparency principle further would awaken the public to the massive amounts of international tax avoidance today known only to specialists.

## II. THE PROBLEM IS REAL.

I am fortunate to have spent 30 years in private practice, where my clients largely comprised multinational firms, to have served at the Joint Committee on Taxation, where we worked on international tax law design and compliance issues, and now to work as an academic, with the time and the freedom to do research on international tax law policy from both legal and economic perspectives. Drawing on my experience and research, I am confident that U.S. multinational firms, as well as multinational firms resident in other countries, today engage in large-scale base erosion and profit-shifting – what in my academic papers I have labeled the generation of “stateless income.”<sup>1</sup>

In 2011, this Committee published a “Discussion Draft” of a possible new U.S. international tax system applicable to foreign direct investment. For the reasons developed in this testimony I do not agree with every policy that the Discussion Draft endorses, but it is unquestionable that the Discussion Draft and accompanying materials reflect a great deal of thoughtful work. In particular, I believe that the Committee should be commended for acknowledging from the start that stateless income generation is inconsistent with the premises of any well-designed territorial tax system, and for outlining some possible anti-abuse and thin capitalization rules that would address aspects of the issue.<sup>2</sup> This hearing also stands as a testament to the Committee’s determination to address the consequences of what I think of as “unprotected territoriality.” But recent developments suggest that the Committee, and fiscal authorities around the world, have underestimated the magnitude of the problem, and that stronger anti-abuse measures are urgently required.

---

<sup>1</sup> *Stateless Income*, 11 Florida Tax Rev. 699 (2011); *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011); *Through a Latte, Darkly: Starbucks’ Stateless Income Planning* (draft of May 28, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2264384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264384)), forthcoming, Tax Notes.

<sup>2</sup> Edward Kleinbard, *Three Cheers for Dave Camp*, 138 Tax Notes 619 (Feb. 4, 2013).

*The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011), explores in detail how stateless income technologies undermine the (usually unstated) premises of standard theoretical justifications of territorial tax systems.

One way to drive home the point that firms are awash in stateless income is to look at the most recent empirical work in this area, by Harry Grubert of the U.S. Treasury and Rosanne Altshuler at Rutgers.<sup>3</sup> Working directly with tax return data, they found that foreign subsidiaries of U.S. firms today enjoy effective tax rates of *less than five percent* on nearly 37 percent of their total income. *Fifty-four percent* of U.S. controlled foreign corporations' total income is taxed at effective rates of 15 percent or less. As Dr. Grubert has noted in another context, these low rates cannot be explained as the consequence of hundreds of billions of dollars of investments in pubs in Ireland. What is more, these total income numbers include large petroleum companies and other natural resources firms, which generally are stuck with very high foreign tax rates that cannot be avoided, due to the fixed location of those resources. If natural resources firms were excluded, the proportion of super low-taxed total income would increase.

In classic academic style, Drs. Grubert and Altshuler buried the lede deep in their paper, but these hard data drawn from actual tax returns are irrefutable proof of the magnitude of stateless income generation in the wild. Corroboration can be found in firms' financial statements<sup>4</sup> and, indirectly in their extraordinary hoards of offshore cash (and the rapid rise of those cash balances), now totaling nearly \$2 trillion.<sup>5</sup>

It sometimes is argued that only high-tech and pharmaceutical firms take advantage of stateless income generation technologies, because they own high-value intangibles that they can locate in a tax haven, and thereby direct royalties to that intangibles ownership vehicle. It certainly is true that such firms are the beneficiaries of extraordinarily low effective tax rates on their foreign income – often in the single digits – and that they rely heavily on artificial arrangements that purportedly transfer the ownership of those intangibles to wholly-owned subsidiaries that conveniently claim residence in very low-tax jurisdictions (or in the case of Apple, claim to be resident

<sup>3</sup> Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, draft of May 12, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2245128](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245128).

<sup>4</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 739 (2011) (Microsoft effective foreign tax rate of 4 percent, and Google effective foreign tax rate of 2.4 percent).

<sup>5</sup> Wall St. J., CFO Journal, *Indefinitely Reinvested Foreign Earnings on the Rise*, May 7, 2013.

nowhere at all – thereby extending the concept of stateless income to include stateless companies).

The Senate’s Permanent Subcommittee on Investigations (PSI) recently released a case study of Apple’s stateless income generation strategies, which it used as background information for its hearing on May 21<sup>st</sup> on this topic.<sup>6</sup> It is useful to reflect on the lessons of that hearing for a minute.

What struck me as most remarkable about the PSI report and the hearing itself was the baldness of Apple’s tax planning. It did not involve “Double Irish Dutch Sandwich” structures, exotic forms of Lichtenstein trusts or reliance on obscure tax treaties. Instead, the entirety of the business arrangements that explain why Apple paid virtually no tax anywhere in the world on \$38 billion of income in the period 2009-11 alone from research and development work conducted in California boils down to this: in 1980 Apple created a shell company subsidiary in Ireland, capitalized it, and entered into a special kind of contract with this shell company (a “cost sharing agreement”), in which the shell company returned to Apple some of the capital seeded to it by Apple, thereby first purportedly acquiring ownership in all of Apple’s intangible assets outside the Americas. This description is a bit simplified, but in essence, that is the entirety of the story.

I refer to Apple’s Irish subsidiaries that purportedly own and exploit some of the world’s most valuable assets as “shell companies” because they are. Until 2012, the key Irish subsidiary (Apple Sales International) had no employees and no independent ability to act according to its own perceived interests. What little activity the shell companies performed (“negotiating” a cost sharing agreement with the parent company, where the shell companies act through the mouthpiece of senior Apple Inc. employees who were ‘dual hatted’ to the Irish companies as well, and “negotiating” contracts with third party manufacturers of Apple products, like Foxconn, when the record showed that those contracts again were in fact negotiated by Apple Inc. employees, and just mirror the

---

<sup>6</sup> *Memorandum to the Members of the Permanent Subcommittee on Investigations Re: Offshore Profit Shifting and the U.S Tax Code – Part 2 (Apple Inc.)*, May 21, 2013, available at [http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code\\_-part-2](http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2).

contracts used by Apple Inc.) were not in any way performed by actors independent of Apple Inc. Nor have the subsidiaries done anything with their crown jewel intangible assets that is separate from what Apple Inc. does. These truly are shell companies.

One issue that the Apple case study therefore presents is not where the "minds and management" of the Irish shell companies might be, but whether they have any minds at all? Do they really have the corporate mental capacity to enter into cost sharing agreements of such importance? If closely examined, would the cost sharing agreement hold up as a bona fide agreement entered into by two companies with their own resources, risk appetites and executives? Of course at some ultimate level this question is circular, in that subsidiaries ultimately are controlled by parent companies, but in other cases with which I am familiar, extensive and expensive efforts were made to give substance and at least the flavor of independence to the subsidiary.

In watching the PSI hearing, I understood Apple's Chief Financial Officer to argue that, because the original cost sharing agreement was executed at the very beginning of Apple Time (1980), it therefore cannot now be challenged as ineffective in producing the tax magic ascribed to it. I respectfully suggest that in this he confused the enduring authority of his cost sharing agreement with the tablets brought down from the mountain by Moses.

Also during the hearing, Apple's Chief Executive Officer, Tim Cook, several times made what I thought was an admission against tax interest, when he said that 95 percent of Apple's collective creative genius was located in a single zip code in Cupertino CA. To the same effect, the PSI report found that less than one percent of Apple's worldwide research and development was conducted by its Irish subsidiaries, and that in 2011, 95 percent of Apple's worldwide research and development was conducted in California.<sup>7</sup> As policymakers, it is appropriate for this Committee to ask whether cost sharing agreements as coarsely constructed as this one seems to be really are efficacious in shifting \$74 billion in income over the four year period 2009-12 from this Cupertino-centric creative genius to a stateless company.

---

<sup>7</sup> PSI Report p. 28.

The Apple hearing generated a great deal of interest around the world. In many cases the lesson drawn from the hearing has taken the form of a general belief that the problem lies with multinational high-tech and pharmaceutical firms. But it simply is not the case that stateless income generation is their unique bailiwick. That is the point of my new paper, *Through a Latte, Darkly: Starbucks' Stateless Income Planning*. Starbucks follows a classic bricks and mortar retail business model, with direct customer interactions in thousands of “high street” locations in high-tax countries around the world. Moreover, Starbucks is not a firm driven by hugely valuable identifiable intangibles that are separate from its business model, which it employs whenever it deals with those retail customers. Nonetheless, it appears that Starbucks enjoys a much lower effective tax rate on its non-U.S. income than would be predicted by looking at a weighted average of the tax rates in the countries in which it does business. To put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can.

### III. MYTHS AND MISUNDERSTANDINGS.

No one stands in defense of the current U.S. international tax system applicable to foreign direct investment. The Apple hearing, press articles and comments filed with this Committee in response to its Discussion Draft all represent a healthy and widely-shared interest in improving the current system, even if proposed solutions vary. But current debates often are marred by the injection into the arguments of some recurring myths and misunderstandings. In the remainder of this section I address some of these.

#### A. Myth I: We Should Cheer When Our Companies Avoid Foreign Taxes.

It is intuitively appealing to argue that when “our” multinationals employ stateless income technologies to minimize their foreign tax liabilities, the outcome is something we should cheer rather than criticize. After all, lower foreign taxes means more net income for “our” companies, and at least under current law, the highly theoretical prospect of higher U.S. tax revenues when the money is fully repatriated (because there will be smaller foreign tax credits to shelter the income).

The argument is interesting for its implicit assumption that companies really do have nationalities, and that we sometimes mentally equate “our” companies with, say, U.S. Olympic athletes in international competition. But the intuition that we should cheer when our corporate athletes minimize their foreign tax liabilities is false, for a number of reasons.

The first reason was one driven home by the Apple PSI hearing: what appears facially to be “foreign” income in fact often more properly should be classified as U.S. income in the first place. In cases like this, apparent foreign tax avoidance is in fact an extension of U.S. tax avoidance, and all Americans are the poorer for the missing tax revenues.

The second reason we should care about foreign tax avoidance in the service of stateless income generation is that under current law streams of very low-taxed stateless income enable U.S. firms to engage in tax arbitrage that erodes the U.S. domestic corporate tax base. A U.S. firm has an incentive to capitalize its foreign subsidiaries with equity supplied by the parent company, to maximize the group’s stateless income, and to overleverage the U.S. parent company with third-party debt. By doing so firms can deduct their *global* interest expense against their *U.S.* domestic tax base.<sup>8</sup> The end result is that it is not simply foreign tax revenues that have disappeared, but also U.S. tax revenues on U.S. domestic income. In turn, the one rule that today purports to limit this overleveraging of the U.S. parent (by limiting foreign tax credits available to the U.S. parent) simply has no bite when foreign tax rates are driven to absurdly low levels.

The third reason we should care about stateless income, even when it appears that foreign countries, and not the United States, suffer the immediate tax revenue losses, is a bit subtler. We live today in a globalized world of deep and liquid capital markets, and few constraints on the cross-border movement of capital. Most economists begin their analyses of international tax policy from the premise that these conditions should mean that risk-adjusted *after-tax* returns are roughly the same everywhere in the world. If this

---

<sup>8</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 724-25, 757-58 (2011).

were not true, investors would flock to the jurisdiction offering better returns for the same risk, until the influx of new capital drove down those returns.

In turn, this means that acceptable pretax returns must be higher in high-tax countries, so that their after-tax returns reach the global level. This is the real cost of higher corporate taxes, for example: it is not that investors obtain lower after-tax returns, but rather that the pool of capital invested in such businesses is smaller, because some projects that would be feasible in a lower tax rate environment do not achieve the required global after-tax rate of return. Investors simply decline to make these investments, rather than suffer lower returns.

But stateless income planning undermines this neat story. If a U.S. firm can invest in a *high-tax* foreign country, with its high pretax returns, and then avoid paying the tax that is associated with returns in that country, the U.S. firm can generate supersized returns on its money – what I call “tax rents.”<sup>9</sup> For technical reasons, and the Apple Inc. story notwithstanding, it often is easier as a U.S. tax matter to shift profits from a high-tax foreign country to a low-tax one than it is to shift profits from the United States to a tax haven. What this means is that, when the United States turns a blind eye to stateless income planning, it inadvertently encourages U.S. firms to prefer foreign investment over U.S. investment – not investment directly in real businesses in low-tax jurisdictions (how many Irish pubs are there to acquire?), but rather real businesses in *high-tax* foreign jurisdictions, to serve as the raw feedstock for the ultimate end product: super low-taxed income, or in other words, tax rents.

The final reason to object to U.S. firms’ avid pursuit of stateless income is international comity. The United States is not just a capital exporter through foreign direct investment; it also is a host country to inbound direct investment from foreign multinational firms. It would be foolish to think that foreign multinationals do not play the stateless income game, with the United States as host country as the tax revenue loser. Similarly, it is a fool’s game to imagine that we can encourage “our” multinationals to game the tax systems of other countries, while successfully defending our borders from

---

<sup>9</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 752-57 (2011). *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011) considers in detail how stateless income undermines the global equilibrium story that is the cornerstone of the policy case for a territorial tax system.



the same sort of strategies. This is trade war by another name, in which the United States effectively is subsidizing exports (in this case, of capital) and penalizing imports. Like all trade wars, it will end badly, in a beggar-thy-neighbor race to the bottom, where multinational firms collectively will be the winners, and taxing jurisdictions the losers.

The lesson is that international recognition of the importance of the stateless income problem, and international consensus on solutions, are urgently required. This is why the OECD's report on base erosion and profit shifting was so important, and why the United States should vigorously push its peer countries in forums like the OECD and the G-8 to address the issue to recognize this for the global problem that it is. U.S. firms may be the world leaders in tax avoidance technologies, but every multinational has learned the tricks of this business. The work of the OECD and other international institutions should not be allowed to degenerate into an unproductive bashing of U.S. firms as the unique locus of the problem.

The OECD and other international forums also need to be mindful of the bad habits of policymakers worldwide to try to steal a march on other countries by arguing that others should be bound to more rigorous standards, while they continue to subsidize the international exploits of their national champions. Some countries (e.g. the United Kingdom) appear to me, as an outsider, to be of two minds on these issues: outraged that as host countries they are the victims of stateless income revenue deprecations, and at the same time committed to offering multinational firms a particularly convenient flag of residence from which to base their international tax avoidance activities. As I suggested earlier, this is just a sort of subsurface trade war by another name, and if not reversed leads to a beggar-thy-neighbor race to the bottom that impedes meaningful substantive progress.

B. Myth II: Firms' Money is Trapped Abroad, to Our Great Detriment.

As noted earlier, U.S. firms today have nearly \$2 trillion in offshore so-called "permanently reinvested earnings." Some of that \$2 trillion is invested in real businesses around the world, but a large fraction is held in cash (in the broadest sense, including bank deposits, short-term government securities, commercial paper and money market

fund shares).<sup>10</sup> It is intuitively appealing to argue that all of this “trapped” cash is lying fallow, as if it were buried in a backyard in Zug, and that if only a repatriation holiday or the like were bolted onto a tax reform package, the U.S. economy could be set to humming again.

There are a great many answers to this argument. One is that nothing is trapped at all: firms choose to leave their cash offshore because the costs to them of doing so are lower – much lower – than paying the U.S. tax that is part of the basic deal to which they signed up when they set their foreign structures in place. Another is the evidence from the 2004 tax repatriation – a rare natural experiment in alternative tax policies – that showed that the large cash repatriations that followed from that tax holiday in net terms funded shareholder dividends and stock buy-backs, not structural investments in the U.S. real economy.<sup>11</sup>

I want to make some different points. The extraordinary sums of cash held offshore by some U.S. firms – \$102 billion, in the case of Apple Inc. – is the telltale mark of successful stateless income strategies in operation. But that cash is not lying fallow. No Chief Financial Officer of a U.S. firm invests the firm’s surplus offshore cash (that is, cash not comprising working capital of foreign operations) in anything other than U.S. dollar investments, because nonfinancial firms are not in business to gamble on currency movements. In turn, every U.S. dollar fixed-income asset – a U.S. Treasury note, a bank account, an interest in a money market fund – held “offshore” is on the other side a dollar *liability* of some U.S. person.<sup>12</sup> This simply means that the money is at work in the U.S. economy. It might not have found its absolute optimal home (but see the next paragraph), but it is financing the U.S. debt, or bank loans to U.S. businesses, or the like.

Moreover, as a practical matter “offshore” funds are easily repatriated tax-free today. Apple Inc. just reminded us all how to do so. It recently borrowed \$17 billion in

<sup>10</sup> One recent empirical study of this question is Jennifer Blouin, Linda Krull and Leslie Robinson, *Where in the World Are “Permanently Reinvested” Foreign Earnings?*, Sept. 2012, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2154662](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154662).

<sup>11</sup> The history of the 2004 experiment and some of the research results from studying it are summarized in Edward Kleinbard and Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 Tax Notes 1191 (Sept. 22, 2008).

<sup>12</sup> Obviously there can be intermediary institutions along the way.

the capital markets to fund stock buy-backs and dividends – exactly how the 2004 experience suggests a repatriation holiday would be used today. Conceptually, one can imagine that interest earned on \$17 billion of its offshore cash hoard is currently repatriated to pay the interest costs on that borrowing, resulting in a wash for tax purposes (the interest income from the investment of the cash hoard is reported in the United States, but is offset by the third party interest expense). Indeed, given Apple’s superior credit rating, it might conceptually make a spread on the transaction. In turn, Apple can roll over both its U.S. domestic indebtedness and its offshore dollar investments from time to time, thereby leaving it indefinitely in exactly the same net economic position as if it repatriated \$17 billion tax free today to fund stock repurchases. So in practical effect Apple did just repatriate \$17 billion tax-free to buy back stock – it is just that no one noticed.

Finally, when economists have happy dreams, they dream of efficient taxes. In ordinary situations all taxes incur “deadweight loss” – the cost to the economy of the transaction not undertaken because its returns after-tax are too low, even though its pretax returns would have cleared the hurdle. But the \$2 trillion in offshore permanently reinvested earnings occupies a different place, because taxing those earnings as part of the transition to an entirely new international tax system will have no effect on future behavior, since the earnings hoard relates entirely to the past. Thus demands for a very low transition tax rate on the repatriation of existing foreign earnings in the context of tax reform are precisely backwards as an economic matter. We should tax those earnings at whatever rate we need to help fund business tax reform, and economists nonetheless will sleep easy, because this for once will be an efficient tax.

#### C. Myth III: Everything That U.S. Firms Do is “Legal.”

When reporters and commentators grapple with events like the Apple PSI hearing, they invariably begin by framing the issue as whether the firm in question did anything “illegal.” This framing makes anyone who has worked in this field wince. Not reporting cash income is illegal; fabricating the existence of inventory is illegal. No one to my knowledge has ever suggested that in their international tax planning U.S. multinational firms have done anything remotely illegal.

The problem is that observers then jump to the opposite label, and declare that everything that U.S. firms do by way of stateless income planning must therefore be “legal.” But this is a meaningless phrase in this context.

The fact is that every large U.S. firm is audited by the Internal Revenue Service on a continuous basis. It is a bit too cynical to describe a firm’s tax return as filed as just an opening bid, but firms do take positions that they expect to be challenged, they do establish accounting reserves for uncertain tax positions, and they often do settle tax disputes (most commonly at the administrative level) by paying additional tax. To a current or former practitioner, the question is not whether a particular firm’s stateless income planning is “legal,” but rather whether that planning can be characterized as inappropriately aggressive.

Very aggressive tax planning sometimes leads to the assertion by the Internal Revenue Service of penalties in addition to back tax, but realistically it must be remembered that no one knows a firm’s business as well as does that firm itself, and further that firms typically have available to them far greater resources to defend their tax return positions than the Internal Revenue Service can devote to attacking them. So it is a depressing truth, particularly in fields as complex and fact-intensive as transfer pricing, that smart aggressive tax behavior is rewarded, at least in this world.

Large multinational firms thus achieve tax results that they would not obtain if the energies available to the two sides of the argument were more evenly matched. This in turn has important repercussions for tax system design. It means that a complex and highly fact-driven international corporate tax system invariably will lead to lower tax revenues than might be expected under more neutral terms of engagement, and it means that the corporate tax system in turn will have a negative spillover into personal tax collections, through a degradation of individuals’ confidence in the fairness of the tax system.

IV. WHAT THEN SHOULD WE DO?

Again, I appreciate the seriousness of purpose behind this Committee's international tax reform Discussion Draft. But for reasons implicit in the earlier discussion, I think that its anti-abuse rules are too complex and too narrowly constructed, and that the key parameters of its thin capitalization rule must be robustly specified if it is to accomplish its purpose. (I also believe that a thin capitalization rule is needed in the wholly-domestic context as well.) The situation is quite desperate, as evidenced by the ease with which a quintessentially retail firm like Starbucks has been able to generate stateless income, and we must ensure that the future U.S. international tax system is not only "competitive" but also appropriate in the outcomes it engenders.

I recognize that there is something of a consensus around the idea of a territorial system with anti-abuse constraints (or a "hybrid" system, as some prefer), but I respectfully submit that there is a far simpler alternative that is more resistant to tax gaming, that is "competitive," and that is economically defensible. I have in mind genuine worldwide tax consolidation, combined with a corporate tax rate squarely in the middle of the pack of peer countries' rates. Worldwide consolidation is not the same as "ending deferral," because true worldwide tax consolidation means that foreign losses are currently deductible against domestic income. Symmetry in treatment between income and loss is an important economic desideratum.

I developed this proposal at length in *The Lessons of Stateless Income*,<sup>13</sup> but, very briefly, imagine a U.S. tax system that taxes U.S. resident companies on their worldwide net income at a 25 percent tax rate, that preserves a foreign tax credit, and that introduces a thin capitalization rule. If it helps, one can visualize my proposal as a territorial tax system with a 25 percent worldwide (not per country) minimum tax – the economic effects are the same.

Financial accounting norms of course require worldwide consolidation in presenting the results of a multinational firm's activities. Tax laws might do well to follow the same fundamental approach to presenting the financial results of multinational enterprises, because only a consolidated perspective reflects the reality that these are

---

<sup>13</sup> *The Lessons of Stateless Income*, 65 Tax Law Rev. 99, 152-68 (2011)

tightly integrated global enterprises with internal synergies that cannot be assigned to particular jurisdictions.

The resulting system is simple and, more important, highly resistant to tax gaming, because there are no positive returns to base erosion or profit shifting. What is more, my proposed system is “competitive,” once we reclaim the word “competitive” to mean competitive with the tax environment that foreign domestic firms actually face in the country in which they operate, rather than a system that, like current law, or like unprotected territoriality, heavily subsidizes foreign investment, at the expense of our own domestic economy.

The system I propose is competitive by virtue of the worldwide tax rate that we choose comporting closely with the consensus rates adopted by peer countries. It is true that other multinationals might face lower effective rates if they are allowed to reap the rewards of rampant unprotected territoriality, but that is why the United States needs to assert leadership in urging all the major economies of the world to recognize that they have a shared interest in abandoning their under the table tax trade wars. By moving past these beggar-thy-neighbor policies, jurisdictions can eliminate the revenue costs and economic dislocations of stateless income.

Finally, there are some countries that have materially lower corporate tax rates than 25 percent. But these jurisdictions have relatively small real economies. The Republic of Ireland has a population of 4.6 million, and Singapore just over 5 million. Added together the populations of these two low-tax countries are smaller than the population of Los Angeles County. And of course the tax rate averaging implicit in the foreign tax credit mechanism can alleviate a great deal of pain even in respect of real investments in low-tax locales.

In my academic work I tried to respond to all the standard criticisms of my preferred approach, but I want to highlight just two here. First, it usually is observed that everybody else has moved to a territorial tax system – but so what? European countries have little choice in what they call their systems, by virtue of the constraints imposed on them by European Court of Justice. And as I observed above, once one concedes that there are no “pure” territorial tax systems, but rather only hybrids, then my proposal can

be recast as just another hybrid – in this case, a territorial tax with a 25 percent global minimum tax on foreign income. What matters are outcomes, not labels.

Second, it sometimes is asserted that my suggested system would encourage start-ups to incorporate outside the United States, to avoid the consequences of U.S. residence. One answer to that is that the definition of corporate residence needs to be updated to reflect “mind and management” principles.<sup>14</sup> As the Apple PSI hearing implied, this should be done regardless of the larger tax reform debate; were it the law, Apple’s Irish subsidiaries would have been viewed, in accordance with their economic substance, as U.S. businesses. But another, even more remarkable point follows from recent empirical research by Professor Susan Morse at the University of Texas Law School. There are important tax incentives *today* to organizing a new enterprise for which international operations are a rational hope as an offshore entity, yet Professor Morse and her colleague found that new businesses overwhelmingly were structured as U.S. firms, even when the new firm has “global ambitions.”<sup>15</sup>

I therefore believe that a true worldwide tax consolidation system combined with a tax rate approximating 25 percent should be the base case for this Committee’s decision making. If other tax systems can be designed that are more economically efficient, net of the administrative issues that I believe to loom large in the entire area of international taxation, or that have other advantages, that is fine, but as an overall compromise among competing goals I doubt that you will find a better solution.

If the Committee continues with an approach closer to that of the Discussion Draft, then I think it desirable to embrace a per-country minimum tax, along the general lines suggested by Grubert and Altshuler in the paper I cited earlier. A minimum tax is much easier to specify and to administer than is a tax on intangible income, for example. As a practical matter, however, this Committee should appreciate that the floor you pick

---

<sup>14</sup> Mr. Doggett has introduced legislation that, among other matters, would do just this.

<sup>15</sup> Susan Morse, *Startup Ltd.*, Fla. Tax Rev., forthcoming (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2275072](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2275072)); Eric Allen and Susan Morse, *Tax Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet*, Nat’l Tax J., forthcoming (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1950760](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760)).

(the minimum tax) will become a foreign tax ceiling as well. Every U.S.-based multinational firm will continue to employ the same stateless income strategies that it does today, except that it will stop when it has managed its foreign effective tax rates down to where the minimum tax would bite.

Finally, without regard to the fate of tax reform legislation, I urge the Committee to work with other Committees of the House to put onto a fast track legislation requiring every U.S. firm to publish a worldwide disclosure matrix of its actual tax burdens by jurisdiction.<sup>16</sup> Tax transparency rules are not a substitute for substantive international tax reform, but they would enable tax authorities to identify possible patterns of inappropriate income shifting, thereby making better use of limited audit resources. A transparency principle further would awaken the public to the massive amounts of international tax avoidance today known only to specialists.

To anticipate the argument that a worldwide tax disclosure matrix would reveal proprietary information about a firm's real business operations, the matrix could contemplate some aggregation of data. For example, it might divide firms' tax burdens into buckets by effective tax rates, in 5 percentage point increments, and then lump all income taxed at effective rates above 25 percent into one bucket. Income attributable to a particular country that was less than two percent of the firm's worldwide income could be lumped into a category of "other." Income would be presented by reference to the accounting principles followed in preparing the firm's consolidated worldwide financial statements.

The idea of worldwide disclosure of per-jurisdiction income and actual tax paid has very recently gained momentum around the world. The OECD's current *Base Erosion and Profit Shifting* report, for example, stresses that it is now time to emphasize transparency with regard to the effective tax rates of multinational enterprises.<sup>17</sup> And in

---

<sup>16</sup> I develop this suggestion in a bit more detail in *Through a Latte, Darkly: Starbucks' Stateless Income Planning*, (draft of May 28, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2264384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264384)), forthcoming, Tax Notes.

<sup>17</sup> OECD, *Base Erosion and Profit Shifting*, at 6 and 47 (OECD 2013).



early May 2013 the European Union took important first steps in this direction, when it announced that it would press forward with legislation this summer that would require:

[D]isclosure of information such as the nature of the company's activities and its geographical location, turn-over, number of employees on a full-time equivalent basis, profit or loss before tax, tax on profit or loss, and public subsidies received on a country-by-country basis on the trading of a group as a whole – in order to monitor respect for proper transfer pricing rules.<sup>18</sup>

The United States should join these initiatives, and do so on an accelerated timetable.

---

<sup>18</sup> European Union Committee on Economic and Monetary Affairs, Report on Fight Against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI)), Par. 48 (May 2, 2013).

Chairman CAMP. Mr. Oosterhuis, you are recognized for 5 minutes.

**STATEMENT OF MR. PAUL OOSTERHUIS, PARTNER, SKADDEN ARPS SLATE MEAGER & FLOM LLP**

Mr. OOSTERHUIS. Thank you. I appreciate the opportunity to be here. We have had a lot of catchy phrases and indeed some fairly boisterous hearings on both sides of the Atlantic on this issue over the last several months, and it is indeed welcome to have a more considered debate and discussion of a topic that is very difficult and very important.

We are building in tax reform a set of rules that we hope will be enacted this year or next year that will replace rules enacted in 1986 that lived for 27, 28 years, and they replaced rules that were enacted in 1962 that lived for 24 years before they were revised. So we are planning for the very long run. That means, to my mind, we have to be very careful what we do, because we can cause long-run distortions in the economy in our effort to try to fix current short-term distortions in international taxation when you are planning something for the run.

Income taxes are, for most successful companies that are multinationals, probably the largest single non-cost-of-goods expense that they have. It is not at all surprising that they devote substantial resources to minimizing that tax globally in the interest of their shareholders. They ought to do that.

We operate and other countries operate under a system of what we call arm's-length pricing. That rewards activities, yes, and it rewards financial risk, financial investments, financial costs. For example, R&D is a major product development cost; if you are bearing the risk of that cost in a particular jurisdiction under those principles, that jurisdiction deserves a reward if you are successful.

We have talked today about many successful companies in the other hearings' focus on Apple and Google. We don't see much attention spent on Wang or on Cullinet Software—my first software company that died; it was a great company back in the 1980s—or Atari, or even AOL, or other companies who may well have used these strategies, but had them backfire on them because they book costs in low-tax jurisdictions, where the deduction wasn't worth very much, rather than booking them in high-tax jurisdictions, where their losses at least could be bought by somebody else.

Governments are joint venture partners of multinational companies. Governments imposing income taxes are joint venture partners with companies. And companies obviously, if they think they are going to be successful, prefer to have a joint venture partner that is going to take a small share of the profits and a small share of the losses. Companies prefer to move their investments and, to the extent they need to, their economic activities to lower-tax jurisdictions rather than high-tax jurisdictions. There is nothing surprising about that than under present law. There is nothing evil about that under present law.

The other feature of present law is that arm's-length pricing is not a science. You don't have a determination of a single price that is the right price. Arm's-length pricing is a range, and in many cases it is a very broad range. (If I had time, I would tell you a

few stories from practice about how broad that range can be, even when it is countries like the U.S. and the U.K. trying to decide the right price.) And when there is a broad range of reasonable prices, it is not surprising that the companies bias their transfer pricing so that the favorable side of the range would end up in a low-tax country and the unfavorable side in high-tax countries. And that is true whether the company is based in the U.K., or the U.S., or France, or Japan or anywhere else in the world. It is a natural outgrowth of the system that we have had for the last 40 years.

As income has become more a function of valuable intangibles and not bricks and mortar and equipment, as the kinds of products that get high value have low transportation costs—pills, software, things like that—this international tax planning has grown, and that is why we see numbers that have grown so much over the last few years.

The pendulum, in my judgment, is at its peak. Governments are now waking up to the extent of taxplanning. The IRS woke up to it a few years ago and established a new unit in LB&I to centralize and expand their transfer pricing enforcement, and I think that, from a government's perspective, holds substantial promise. Other countries are now starting to do the same thing. They may be a little behind the IRS, but they are starting to do the same thing.

So we shouldn't just look at the pendulum at its peak, we should look at the longer run, because we are talking about a system that we want to enact and to last for 25 years.

With that, I would be glad to take any questions.

Chairman CAMP. Thank you very much.

[The prepared statement of Mr. Oosterhuis follows:]

**Statement of Paul W. Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom  
LLP**

**Testimony Before the House Committee on Ways and Means**

**June 13, 2013**

It is my pleasure to appear before you to discuss certain issues relating to corporate profit shifting and tax base erosion under current United States income tax rules. I am appearing on my own behalf, and not on behalf of any client or organization. As such, the views I express here today are solely my own.

**I. Introduction**

A series of recent events – including the recent hearings held by the Senate’s Permanent Subcommittee on Investigations regarding “Offshore Profit Shifting and the U.S. Tax Code,” the OECD’s ongoing project regarding base erosion and profit shifting (the “BEPS” project), and hearings held in the U.K. parliament regarding the taxation of multinational corporations – have brought to light concerns about the taxation of multinational corporations. The focus of these events has been on the ability of multinational corporations to locate their profits in low-tax jurisdictions through intercompany transactions and thereby minimize their worldwide effective tax rate.

In the recent PSI hearing regarding Apple’s tax structure, much of the focus was on the taxation of Apple’s income that is attributable to its non-U.S. sales. As was disclosed in the hearing, that income is largely earned by Irish-incorporated – though not Irish tax resident – affiliates of Apple that are party to a cost-sharing arrangement under which they fund the development of and own the rights to intangible property that is used in Apple products sold outside the United States. The large profits earned by these entities – combined with the minimal tax they paid – has led to increased criticism of multinational corporate “profit shifting”

generally, and more specifically has caused some to question the validity of cost sharing arrangements as a means of allocating income and expenses within a multinational corporate group. I question whether that is the right lesson to learn from the recent PSI hearings; a number of cautionary points should be considered when assessing the scope of the profit shifting problem and the wisdom of any proposed solutions.

## **II. Distinguishing Income from U.S. and Foreign Sales**

When discussing the problem of profit shifting and base erosion the first question that must be asked is: whose tax base is being eroded? From a U.S. perspective, the answer to this question is particularly thorny in the context of sales of products outside the United States. Does the profit from those sales properly belong in the United States, or should it be subject to taxation in the first instance in a foreign country, i.e., the “market,” “destination,” or “source” country where the good is sold? Where product development activities occur in one country – say, the United States – the funding for that development occurs in another – perhaps an Irish affiliate – and the sale occurs in yet a third country – for example, the United Kingdom – it is not remotely clear that the bulk of the income from that ultimate non-U.S. sale is properly allocable to the United States such that the income can be said to have been inappropriately “shifted” outside the United States if it is reported as earned elsewhere. This is particularly true for consumer products where much of the value lies in consumer preferences and brand awareness, both items of value that typically inhere in the market country and not in the location of product development activities or in the parent’s country of residence.

Indeed, much of the recent criticism of multinational corporate tax practices in the U.K. has focused on precisely this point. U.K. officials, in their criticism of the tax practices of U.S. multinationals like Amazon, Starbucks, and Google – the three companies that were the

focus of the U.K. inquiry – complained that these companies all make substantial income on their sales to U.K. consumers and yet pay little to no U.K. corporate tax. Implicitly or explicitly, these U.K. officials were taking the position that it is the market country – i.e., the location of sales – that should drive the determination of the location of income, and not the place of product development or funding. To the extent multinational companies employ strategies to minimize their U.S. taxable income on foreign sales, it is not clear that income has been “shifted” outside of the United States because it is not clear that that income “belonged” to the United States in the first instance. Certainly the recent hearings in the U.K. indicate that there is no international consensus regarding the proper allocation of such income.

Other countries, including most prominently China and India, two of the fastest growing market countries in the world, maintain a strongly held view that all intangible profit should be taxed in the market country. They argue that because it is their laws that protect the value of intellectual property in transactions with consumers in their country, the income resulting from those transactions is properly taxed there. While their view is obviously not universally accepted, it is consistent with the long-standing U.S. source rule for income from intangible property in the U.S. and the source rules of most other developed countries, which source the income where the intangible property is “used.” The United States would thus likely face strong headwinds in any effort to assert that the location of product development activities should determine the right to tax income.

Whatever position the United States takes, one needs to be consistent. If the United States wants to take the position that income allocation depends on the location of product development activities rather than its place of sale, it must do so no less with foreign-developed and imported products than with U.S.-developed products. Take, for example, the

case of the U.K.-developed drug that is sold in the United States. If we assume that income from a U.S.-developed, but foreign sold, Apple product is properly allocable to the United States, we would have to concede that the U.K. company's income from U.S. pharmaceutical sales properly belongs to the U.K. But that was not the position taken by the Internal Revenue Service in its transfer pricing dispute with Glaxo SmithKline regarding income from the sale of products that were developed in the U.K but sold in the United States. In that case, the IRS took the position that approximately 85% of the profit from the sale of pharmaceutical products in the United States was properly allocable to the United States based on the value inherent in the U.S. market, and that only 15% was attributable to the jurisdictions outside the U.S. which developed, funded and owned most of the product intangibles (i.e., patents), and manufactured the product. According to the IRS the case was settled with the Service getting 60 percent of the amount at issue.<sup>1</sup> If this is correct, then over half of the income from the products sold in the United States was taxed in the United States.

We cannot have it both ways. We cannot ascribe the majority of the value to the market country when we are the market country and to the developing country when we are the developing country. We must therefore be careful in attaching the profit shifting or base erosion label to income that, when fully thought through, we ought not assert is ours to tax in the first instance.

### **III. Foreign Taxation of Income From Foreign Sales**

If there is some merit to the above discussion, and therefore at least some basis for assuming that the market country has a primary claim to tax the income from sales in that

---

<sup>1</sup> The IRS press release announcing the settlement can be found at <http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute>.

country, the question then becomes should the United States care whether or how much tax is actually charged by or paid to the market country. Put differently, if U.S. multinationals are minimizing foreign taxes on their foreign sales by shifting income from the U.K. to Ireland, is that a “bad” thing from our perspective?

Returning to the examples of Starbucks, Amazon, and Google – the companies that were the focus of the inquiries in the U.K. – all of them were earning income from their U.K. sales in jurisdictions outside the U.K. – Ireland, Luxembourg, and the Netherlands. As a result, they paid minimal U.K. tax – and presumably minimal foreign taxes generally – on that income. But if that income is not the United States’ to tax, why should we – rather than the U.K. tax authorities – worry if those companies are employing strategies to minimize their U.K. taxes?

Indeed, that was the position taken in the past when, for example, Congress put the brakes on Treasury and the IRS’s efforts to write regulations that would limit the use of the check-the-box rules to achieve foreign tax minimization. When the IRS announced its intent to write such rules in Notice 98-11, the negative reaction was widespread and the effort was abandoned in the face of congressional scrutiny.<sup>2</sup> And thereafter Congress effectively codified the permissibility of foreign-tax minimization through its enactment of the (temporary though perennially extended) look-through rules of section 954(c)(6), whose primary purpose is to allow multinational corporations to achieve foreign tax minimization without triggering an immediate resulting U.S. tax liability.<sup>3</sup>

---

<sup>2</sup> See Notice 98-35, 1998-2 C.B. 34 (withdrawing Notice 98-11).

<sup>3</sup> More recently, the Obama administration dropped its proposal to repeal the check-the-box rules for foreign entities because the main effect of such repeal would be to unwind U.S. multinationals’ foreign tax minimization planning.



Ultimately, in considering the appropriate reaction to profit shifting and base erosion whose primary impact is *foreign* tax minimization, we must consider carefully whether the United States has an interest in imposing and enforcing rules whose primary beneficiaries are foreign fisces, rather than the U.S. treasury.

It is true that under current law the potential for low-taxed income on foreign sales can encourage U.S. companies to manufacture their products abroad rather than in the U.S. But if that is a concern, the remedy should be to change the rules that force companies to manufacture abroad in order to obtain low-taxed earnings. Base erosion Option C in the international tax reform discussion draft released by this committee offers one approach to achieving this result. Elsewhere I and others have suggested alternative approaches.<sup>4</sup>

#### **IV. Allocating Income Based on Business Activities vs. Business Risks**

In considering whether profit has been improperly shifted or the tax base eroded, it is also critical to keep in mind that it is not only the location of activities but also the location of costs that must be taken into account. If we are to employ arm's-length pricing principles in the context of intercompany transactions, we must recognize the fact that in arm's-length transactions it is the party that bears the costs – and takes the financial risks – of a business that earns the bulk of the return from that business. In contrast, a service provider that conducts activities but does not bear financial costs or risks generally gets only a modest return. Focusing exclusively on where activities – such as product development – are conducted and ignoring the location of the funding for those activities does not give an accurate account of where profits are properly earned, and thus leads to a distorted account of whether profits have been shifted.

---

<sup>4</sup> See Sullivan, Economic Analysis: U.S. Contract Manufacturing and Dave Camp's Option C, 139 Tax Notes 10 (Apr. 1, 2013).

This is no less true where the allocation of costs is done between and among members of a multinational corporate group. Take Apple as an example. Much has been made of the fact that its relocation of funding obligations from the United States to its Irish affiliate pursuant to its cost sharing agreement was all “in-house” and had no actual economic impact on Apple. From a global consolidated group perspective that is surely true. Whether Apple U.S. or Apple Ireland bears a cost does not affect the Apple group’s pre-tax profit calculated on a global consolidated basis. But it can and does affect its after-tax profit in individual countries. Expense deductions in the United States that reduce U.S. taxable income are far more valuable than deductions taken in low-tax jurisdictions. And it certainly affects the United States government, which via the income tax system is effectively an equity investor in Apple U.S. Because the United States taxes net business income, the treasury effectively bears 35% of the cost of Apple’s U.S. business expenses, and is entitled to a return by collecting 35% of Apple’s profits. If a cost is shifted outside the United States such that it is no longer deductible in the United States, then the United States government no longer bears the cost of that deduction and correspondingly loses its entitlement to an appropriate amount of the resulting income. Ignoring the location of business expenses in determining where income should be taxed results in a misallocation of income, and a potential misdiagnosis of the problem of profit shifting.

The problem of ignoring the location of funding costs is not limited to countries asserting taxing jurisdiction based on the location of product development activities. Market countries asserting such jurisdiction also often fail to recognize that taxing intangible property income requires some recognition of the costs of product development.

**V. Is Cost Sharing Part of the Problem or Part of the Solution?**

The three concerns discussed in the three preceding sections – the need to properly distinguish between U.S. and foreign sales, the need to consider our attitude toward foreign tax minimization planning, and the need to give proper credence to the allocation of business expenses and risks – suggest that much of the criticism that has been heaped on cost sharing following the PSI hearing on Apple is overstated and may in fact be counterproductive. Fundamentally, cost sharing arrangements achieve two important goals that align with the above discussion: First, they provide a framework for allocating income based on where sales are made. They thus recognize the principle that, at least with respect to consumer items, much of the value associated with goods like consumer products inheres in the marketplace, which is properly allocated to the market jurisdiction, and not the place of development.<sup>5</sup> Likewise, cost sharing arrangements have the effect of allocating costs to the same jurisdiction that earns the resulting income. They thus match income and expenses – or investment and return – which is appropriate both from the perspective of the entity that bears that cost and from the perspective of the government that is an effective co-venturer in that endeavor.

This is not to say that cost sharing arrangements are free from their fair share of issues. There are questions surrounding how to determine cost sharing buy-in payments (although that has largely been addressed through regulations that were published in proposed form in 2009 and finalized in 2011 which, if anything, take too broad a view of what kind of

---

<sup>5</sup> In this regard, recent indications that the Treasury and IRS may promulgate regulations including in the definition of intangible property for section 367(d) purposes the value associated with foreign goodwill and foreign workforce in place is troubling. Items of property that properly belong to the market country should not be viewed as “belonging” to the United States and therefore subject to taxation upon their supposed outbound transfer. Indeed, strong arguments can be made that section 367(d) is overly broad today as applied to foreign customer-based intangibles developed by foreign branches of U.S. companies.

payment is necessary to “buy into” cost-sharing).<sup>6</sup> In business-to-business transactions the location of sales is a vexing issue. Likewise, there is reasonable disagreement about the types of costs that should be subject to sharing under a cost sharing agreement, and whether the cost reimbursement mechanism under the cost sharing rules adequately compensates the service-providing parties for their development activities.<sup>7</sup>

But these concerns – about which reasonable people can disagree and which could help improve cost sharing agreements at the margins – should not cast doubt on the fundamental wisdom of cost sharing arrangements. I believe these arrangements could provide a model for the taxation of cross-border income because they minimize incentives to move factors of production to reduce global taxes and minimize the friction of determining the proper allocation of intangible profit among taxing jurisdictions.

Today we have what many economists would describe as an “origin-based” income tax system; income is taxed where the relevant input cost and activity factors are located. Since for most multinational companies taxes are the biggest single expense on their financial statement, an origin-based income tax provides large incentives to migrate costs and activities as is necessary to reduce global taxes. We have seen this in the United States; over the past 30 years manufacturing activities in many sectors have migrated abroad, in part as a result of our tax rules that make such foreign manufacturing essential to minimizing the taxation of intangible profits on sales outside the United States.

---

<sup>6</sup> See Treas. Reg. § 1.482-7. It is worth noting that according to the documents released in connection with the PSI hearing, Apple first entered into its cost sharing agreement in 1980, so we are well past any concerns about its buy-in payment.

<sup>7</sup> Arguably the service provider should receive a mark-up on the costs it incurs rather than simple reimbursement for those costs. But in general one would not expect that to be a substantial item. Apple, for example, spends less than 3 percent of its revenues on R&D. Obtaining a 10 percent “profit” on those costs would not substantially impact its U.S. taxable income.

The one factor that economists agree is the most difficult to migrate is sales. The location of customers in consumer businesses is fixed. U.K. customers are not going to move to Ireland to buy Apple products. This leads many economists to advocate what is called a “destination-based” income tax.

Since most cost-sharing agreements allocate income based on third-party sales, they provide a framework for a destination-based allocation of intangible profits for income tax purposes. As a result, cost-sharing companies have no incentive to migrate their product development activities outside the United States. If instead we proceed with an “origin-based” allocation of profits to product development activities, I worry that 30 years from now we could observe a migration of such activities that parallels the migration of manufacturing activities over the past 30 years.

A second fundamental advantage of cost-sharing is that it can be administered. Arm’s-length transfer pricing has been understandably criticized for being, at best, subjective and thus subject to manipulation by taxpayers or, at worst, impossible to administer because of the lack of real world transactions remotely comparable to intercompany intangible property transfers. The sharpest critics of arm’s-length pricing typically suggest that some form of formulary apportionment of income would be preferable.

Yet, the various formulary apportionment proposals that have been put forth in recent years, including the Common Consolidated Corporate Tax Base proposal put forth by the European Union, are in many respects just cost sharing taken to its logical conclusion. Formulary apportionment – at least to the extent that apportionment is based on sales – effectively treats all the costs and income of a corporate group as allocable on a proportionate

basis to the jurisdictions in which the group makes its sales. It thus achieves a perfect matching of income and expenses while allocating all or nearly all intangible profit to market countries.<sup>8</sup>

In my view, rather than being a source of profit shifting and base erosion, cost sharing – with some improvements – may in fact be part of the solution. Indeed, I would argue that major progress on “profit shifting” could be accomplished if all the major developed countries were to mandate cost sharing for inbound as well as outbound product sales, and apply cost sharing not just to product development expenses but to global marketing and G&A expenses as well. It would raise revenue. It would eliminate incentives to migrate product development activities. And in the United States, if it is done together with some modest, but critical, improvements to the subpart F rules – the foreign base company rules in particular – it would also help remove the tax barriers facing those who wish to manufacture in the United States for export to foreign markets.

#### **VI. Implications for Base Erosion in the Context of International Tax Reform**

The themes discussed so far have important implications for any anti-base erosion subpart F proposals that might be adopted in the context of broader international tax reform. No one doubts that in the context of implementing a territorial tax system along the lines detailed in the Discussion Draft released by this committee in October of 2011, new anti-base erosion measures will need to be adopted to ensure that the U.S. tax base is properly protected. The themes and concerns discussed above suggest that base erosion Option C from the Discussion Draft offers a well-designed starting point for crafting an appropriate base erosion proposal

---

<sup>8</sup> The extent to which income is allocated to market countries depends on which factors are used for the apportionment and what weight is given to each of those factors. Traditionally, the three factors of sales, assets, and employees have been used, though jurisdictions employing formulaic apportionment – such as the states in the United States – have tended over time to rely more heavily on location of sales, in part because that is the factor least subject to control and manipulation by the taxpayer.

because it is fundamentally based on the distinction between U.S. sales and foreign sales that is critical to preserving the essential character of a territorial system.

Where transfer pricing rules are insufficient to prevent the profit of U.S. multinationals from sales to U.S. customers from being shifted outside the U.S., an expansion of subpart F to include such profits may well be appropriate. Of course, under current law a principal reason why such profits are outside the U.S. is investment in R&D and plant and equipment by foreign affiliates of U.S. multinationals. Any expansion of subpart F to tax those profits should include transition rules to avoid taxing income attributable to pre-existing investments. Going forward, an expansion of subpart F would prevent erosion of the U.S. tax base and level the playing field with respect to manufacturing activities for the U.S. market.

Whether subpart F should apply to foreign sales of products manufactured outside the United States (as Option C would albeit at a lower rate) is more questionable, and depends in part on whether one thinks that the U.S. tax system should discourage foreign tax minimization. This is an area for caution. At a low rate such a tax would raise little revenue for the United States because it would typically be less expensive for multinationals to unwind their foreign tax planning. But at higher rates the increase in combined U.S. and foreign taxes could have a potential long-run competitive impact on U.S. multinationals. Over time that will inevitably lead to more multinationals incorporating abroad and, to the extent necessary, moving activities abroad.

A few years back I suggested that the major developed countries might work together to adopt CFC rules that constrained this kind of tax planning in a way that would

minimize the competitive impact on any one country's multinationals.<sup>9</sup> I understand the U.S. Treasury may be taking that view in the OECD BEPS discussions. If other major countries were to agree, then the Discussion Draft's Option C (as it applies to foreign sales – or even a variant of the Obama Administration's minimum tax applied to such sales) could make sense. But I am very skeptical other countries are interested in taxing their multinationals in that manner. By and large they see their multinationals as their “champions,” to be encouraged to grow and expand around the world, and thus have little interest in raising revenue from their activities outside their home country. Instead, their focus is taxing the market-related activities of other countries' multinationals.

While I am somewhat skeptical of the base erosion Option C provision taxing (albeit at a reduced rate) intangible profits attributable to foreign sales, I do agree with its companion provision that taxes intangible profits attributable to exports only to the same extent that intangible profits from foreign sales are taxed. That provision goes a long way to leveling the playing field between foreign and domestic manufacturing of products for sales abroad. When combined with the application of subpart F to foreign manufacturing for sales back to the United States, base erosion Option C minimizes the current law incentives to manufacture abroad.

## **VII. Conclusion**

Corporate profit shifting and tax base erosion is an important issue that must be faced by both governments and corporations. But any honest and productive discussion of the topic must begin by first considering where profit *should* be located; only then can we begin to

---

<sup>9</sup> See Oosterhuis, The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy: The Evolution of International Tax Policy - What Would Larry Say?, 33 OHIO N.U. L. REV. 1 (2007).



determine whether it has been improperly shifted. I would suggest that a corporation's place of residence or the location of its activities or how much foreign tax it pays are not likely to provide useful – and certainly not complete – measures of profit shifting. A focus that is geared towards the location of sales and the matching of income and expenses is far more likely to produce useful measures of – and thus productive solutions to – the issue of U.S. profit shifting and base erosion.



Chairman CAMP. Mr. Saint-Amans, a couple of times in your testimony, you mentioned that the base erosion by multinationals could actually place small businesses and other purely domestic companies at a disadvantage. Could you just expand on that a bit for the committee, please?

Mr. SAINT-AMANS. Thank you, Chairman.

Indeed, when you look at the effective tax rates of companies, which is the effective tax burden that they face, it looks like in most of the countries, if not all the countries, the multinationals, which are exposed to international transactions and therefore can play with the different gaps which are there through transfer pricing rules, tax rules, and domestic legislation, they are exposed to a much lower effective tax rate than domestic companies which cannot benefit from these international instruments, and therefore this gap is quite significant, putting domestic businesses at a competitive disadvantage. And this is a distortion which is not good from an economic perspective.

Chairman CAMP. Thank you.

Mr. Oosterhuis, is there something unique to the United States? Because unlike many other countries, we have such a large segment of our economy in intellectual property. Is there something about that—and intangibles—that makes this a more important issue for us than for some other countries?

Mr. OOSTERHUIS. Yes, and I think it makes it a more difficult issue. Why Google and Apple and Microsoft are all U.S. companies, I can't tell you. I am delighted that they are. But I can tell you that their competition is not just domestic. Apple's main competitor is Samsung. HP has huge competitors in companies like Lenovo and Canon. Our pharmaceutical companies' main competitors are companies like Novartis and Glaxo. Even in the consumer products, Procter & Gamble, one of their main competitors is Unilever; Mars is Nestle.

So we are dealing with a lot of U.S. companies that are successful, but a lot of their main competitors are foreign. They operate under territorial systems, and they have governments that see them as champions. For whatever reason, we don't see our multinationals as champion in the same way that the U.K. sees Glaxo, or that Switzerland sees Nestle, or that China sees Lenovo. Why that is, I am not sure. But I think we need to be careful when we do things to our multinationals that are quite different than what their competitors are having done by their home countries.

Chairman CAMP. And you have also observed that option C in this chairman's discussion draft that has been out there approaches neutrality between the development and manufacture of products in the U.S. and those activities that take place abroad.

Now, can you explain how you think that is the case and what kind of behavioral responses we might expect to see from companies if option C were actually enacted into law?

Mr. OOSTERHUIS. Sure. The advantages of option C, to my mind, start from the fundamental point that they differentiate products sold into foreign markets from products sold into the U.S. market. To the extent we worry about base erosion, to my mind, in a territorial world it is largely a concern with respect to products being sold in the U.S. market. That is where there could be incre-

mental base erosion in a territorial system, and, from a revenue point of view, you really have to worry about that.

If you are going to do something like Camp C for products sold back to the U.S. and tax foreign affiliates on that income at normal rates, which is what Camp C does for the IP profit, the intellectual property profit, you may need transition rules, and we can talk about that. But that will help any revenue hemorrhaging and will help any real base erosion of the U.S. tax base for U.S. products.

For foreign products, it is quite a different situation, because for foreign products, in most of these businesses, they are consumer-facing businesses. And so the country where the products are consumed has a large right to tax that income. You will notice in Europe some of the outrage that has been raised lately, particularly in the U.K., has all been focused on inbound companies. Whether it is Starbucks or Google or Amazon, it is all inbound companies and their income in the market country.

And what Camp C does is recognize that we have a much lesser right, if you will, to assert jurisdiction to collect revenue out of that income. And I think that is a very sensible distinction over the long run.

The other thing that Camp C does through the “carrots,” as you described it in your opening statement, is to try to come closer to neutralizing where you locate your manufacturing plants and other similar activities. I think there is more than one way to do that, but I think the goal, while you are differentiating between products that are sold for foreign markets and products that are sold for the U.S. market, if you could try to do measures like Camp C does to neutralize where you manufacture those products, I think that would be an important goal. And that is what Camp C is trying to accomplish.

Chairman CAMP. All right. Thank you.

Mr. Levin is recognized.

Mr. LEVIN. Thank you.

And, again, welcome.

I just wanted to say, Mr. Saint-Amans, I am glad you talked about effective tax rates, because when we look at the corporate tax rate, we really need to look at the effective rate as well as the other rate.

And let me just say, Mr. Oosterhuis, we are proud of American corporations. I think we have as much pride as Europeans. And so, when we talk about tax policy and we talk about how our companies utilize them, it is not because we are not proud of them. It is because we very much want to have a tax system that makes sense for all of us. And I hope that isn't misunderstood.

I am hopeful that we can have—this is such a useful hearing—a lot of discussion among the three of you. So I want to start off, and I will—so maybe we can get you talking with each other, maybe even arguing a bit. Because this is so important. So I am sure my colleagues will pick up and take other pieces of your testimony and have you comment on the others, because we don't do enough of that.

So I want to read for you, Mr. Kleinbard, a sentence or two sentences from your testimony, Mr. Oosterhuis, and ask Mr. Kleinbard to comment. And then maybe one of my colleagues will ask you to

comment on his comments, okay? Because I really want to understand it. I think this is critical to our getting at this important issue.

So this is from the last page of your testimony.

And, Mr. Kleinbard, I will read it to you, though you can see it in his testimony.

Mr. Oosterhuis concludes, "I would suggest that a corporation's place of residence or the location of its activities or how much foreign tax it pays are not likely to provide useful and certainly not complete"—it is modified a bit—"measures of profit shifting. A focus that is geared towards the location of sales and matching of income and expenses is far more likely to produce useful measures of, and thus productive solutions to, the issue of U.S. profit shifting and base erosion."

So I didn't tell you I was going to ask this, but, so we have lively discussion, if you would analyze that from your perspective. And don't pull any punches, okay?

Mr. KLEINBARD. Unlike my usual practice. Okay.

Chairman CAMP. He has never been known to do that.

Mr. LEVIN. I know that. We know each other well. All of us know you.

Mr. KLEINBARD. There is a lot bundled in those thoughts of Paul's.

Let me begin by observing that there, at least in my view, is a fundamental conflict between the idea of looking to the place of sales on the one hand and the policy recommendations that are contained in Paul's testimony on the other.

In my world view, we ought to end up with knock-down, drag-out fights all the time between the country of residence and the country of what I call source, or the market country, where things are actually sold. That is not what we have today, and that is not, I think, what a world in which cost-sharing agreements are given primacy would lead to.

Those lead, in fact, to a siphoning off of revenues neither to the home country nor to the source country. That is the point of the Apple hearing. It was not that income was being taxed where the sales were; income was being taxed nowhere. So there is a natural tension.

The United States is a great generator of intellectual property, as Paul identified. And the United States may well want to consider carefully whether moving to a destination-based tax system is net a revenue loser or a revenue gain for the United States.

We are the largest single consumption base in the world, so we would pick up revenue from that perspective. We lose revenue from the other perspective, because we would treat sales from intellectual property developed in the United States to customers outside the United States as having no U.S. tax liability associated with it at all.

So, to my way of thinking, there is this important tension between the sentiment and the actual recommendation. There is a very mixed message, I think, as to what is in the best interests of the United States.

And, finally, we should not forget the fact that, although we have open capital markets, although we have an open economy, the fact

is, the last time I looked at the statistics, 84 percent of U.S. firms are owned by U.S. individuals, ultimately. And so there is an identity between U.S. firms and U.S. individuals that is not true in the U.K., for example, where the percentage is much, much lower.

That is why I see taxing the U.S. firm on a worldwide basis as a pretty good substitute for taxing U.S. individuals on their share of the capital income thereby earned.

Mr. LEVIN. Thank you.

Chairman CAMP. All right. Thank you.

Mr. Brady is recognized.

Mr. BRADY. Thank you, Mr. Chairman.

The testimony clearly reveals the need to fix this broken Tax Code and make America far more competitive, make our workers far more competitive around the world.

Mr. Oosterhuis, I want to talk to you about a hybrid system. It seems like the current system we have today makes it difficult for when an American business competes around the world and wins, when they attempt to bring those profits home to reinvest in America, they oftentimes find themselves paying a huge premium to do that.

My question is, should we move to a hybrid system, in effect, an investment-neutral system where companies that compete around the world and make profits, rather than have them stranded, that there would be a lower tax rate so they can reinvest in the U.S. R&D jobs, in manufacturing plants, in dividends that go to shareholders, middle-class families. That those are all positive things for the U.S. economy.

Can you tell me how you view the current code, and would an investment-neutral-type system that would allow those stranded profits to flow back to the United States help make us more competitive?

Mr. OOSTERHUIS. Sure, happy to.

And you absolutely hit on the point that I think some of the base erosion profit split discussion has sidetracked us from keeping a focus on, is that the most broken part of the system as it is today is the fact that your non-U.S. earnings have to stay, if they are low-taxed, have to stay outside the United States and you can't bring them back. We need to eliminate the system that forces companies to leave their earnings offshore.

Ed in his testimony mentions that in Apple's case it is not a problem because they can borrow \$17 billion. Well, not every company is Apple, and, indeed, Apple wasn't Apple 10 years ago. Most companies don't have the flexibility to do that.

I do transactions every day, I have two this week, with foreign companies and U.S. companies buying or selling assets. The most important question is, can I use my offshore cash to buy? And if I am going to sell, am I going to get those proceeds offshore or onshore?

Because cash that is offshore for a U.S. company that would have a high tax cost to come back is a wasted asset. It doesn't help a company's profit-and-loss statement. You can't pay it out to your shareholders. You have to find some effective use for it, and that leads people to pay more for assets that they can buy if outside the United States. It distorts the economy. As foreign earnings have

grown over the last 5 to 10 years, it has become a very large problem, and we need to fix that.

However, hybrid the system needs to be in order to satisfy base-erosion concerns, that hybrid system will likely be better than what we have today with deferral, because the deferral system is really causing some serious problems.

Mr. BRADY. So if we keep the current system worldwide, with a complicated set of provisions to try to offset some of that, do you think that problem continues to grow—

Mr. OOSTERHUIS. Absolutely.

Mr. BRADY [continuing]. And those investment decisions continue to be distorted in the future?

Mr. OOSTERHUIS. Absolutely.

Mr. BRADY. And then, right, a hybrid system could make us more competitive?

Mr. OOSTERHUIS. A system that doesn't do what Ed proposes, in my judgment, which is tax U.S. multinationals at the full statutory rate on their global income, but is truly hybrid with has elements of a territorial system, can be real plus from a competitive perspective for our multinationals and can be designed in a way that minimizes some of the issues of base erosion and profit shifting that we are talking about today.

Mr. BRADY. Well, it just seems to me, finishing up, 95 percent of the world's consumers are outside the United States. We want our companies competing in every corner of the globe and winning. And we want them to have the ability to reinvest those dollars back in the United States for our jobs, for our research and development, for our manufacturing, in order for the economy to grow stronger. So I think that ought to be a focus of where real reform heads.

Mr. Chairman, thank you.

Chairman CAMP. Thank you.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman.

And thank all of you for taking the time out to share your views with us.

Mr. Kleinbard, you have a reputation of not pulling punches; everyone agreed on that. And, of course, the great job that you did for the Joint Committee was certainly bipartisan, so I expect that a lot of that bipartisanship will still be with you.

When you find complete accord with everyone that has reviewed our present tax system that we have to eliminate unfair loopholes and broaden the base and reduce corporate taxes and to have our firms creating jobs here, and since we have known this and that objective appears to be bipartisan in nature, and even to the extent that the private sector, in terms of wanting to know how to plan, have advocated publicly that we should reform the system, why in the world do you find, regardless of which party is in charge, that there doesn't appear to be any sincere movement to make that a priority?

Mr. KLEINBARD. Mr. Rangel, you are asking a political question, and the inner workings of the political system, despite my close study for many years, has always been a bit of a mystery to me.

There ought to be movement. The current system is broken. The current international system is crazy. But more important to me and, frankly, one of the oddest things to me about much of the debate on corporate tax is that the domestic business tax system is broken.

What we need in the United States is lower statutory rates, a broader base, as Mr. Saint-Amans explained, that reduces distortions. The goal should not be to help U.S. firms compete around the world. That is just a subsidy by another name. We finally learned after 100 years that trade subsidies don't work, and the same is true with tax subsidies.

What we want is a robust, successful economy for the United States of America. And the way to get that is to improve the business tax system and to lower rates and broaden the base. We can't afford to lose revenue, in my view.

Mr. RANGEL. Is your answer, Professor, that it is a mystery to you?

Mr. KLEINBARD. It is a mystery to me as to why more progress has not yet been made, yes, sir.

Mr. RANGEL. Does anyone else have any type of answer that you—because I am under the impression that the power of the multinationals that are enjoying this tremendous tax benefit is overwhelming and that people fear politically of interfering with these corporate desires.

Does anyone have any views on that at all? And I hope I am wrong.

Yes, sir?

Mr. SAINT-AMANS. I am not sure I will respond exactly to your question, but I think what—

Mr. RANGEL. No one else is, so—

Mr. SAINT-AMANS [continuing]. Governments and businesses have in mind is to what we call leveling the playing field—

Mr. RANGEL. Yes.

Mr. SAINT-AMANS [continuing]. Making sure that companies from one country are not at a competitive disadvantage with the companies of other countries.

Mr. RANGEL. That is the question, yes.

Mr. SAINT-AMANS. And what has happened over the past 20 years, I think, even though it is implicit, is that high-tax countries, at least in corporate income tax—and there the U.S. is a high-tax country for corporate income tax, as well as a number of European countries—they have kept the high tax probably for, I mean, visibility reasons, but they have organized a system where companies don't actually pay the statutory rate in many European countries, which are territorial systems, but still they—

Mr. RANGEL. Okay. I am sorry to interrupt, but one would know, even if your assumption is correct, that is totally unfair to the companies that are paying the real tax rates. So that is an expansion of the degree of the problem.

Mr. Oosterhuis, do you have any views on this?

Mr. OOSTERHUIS. Well, the one thing I would say, Mr. Rangel, is that I think the multinational community is more ready to embrace tax reform, even if it involves some pain for them, than they have been in the last 20 years.

Mr. RANGEL. They have said that.

Mr. OOSTERHUIS. And I believe it, because I see what happens with CFOs, I see what happens in boardrooms and how the distortions of the current system is causing real problems for our multinationals.

Mr. RANGEL. So you mean everyone is in agreement that we should do it, the corporate world—

Mr. OOSTERHUIS. It is certainly not companies that are keeping reform from happening.

Mr. RANGEL. And, politically, you can't think of any reason why we shouldn't do it.

Mr. OOSTERHUIS. Agreed.

Chairman CAMP. All right, time has expired.

Mr. RANGEL. Thank you.

Chairman CAMP. Mr. Tiberi is recognized.

Mr. TIBERI. Mr. Oosterhuis, you mentioned some American worldwide companies and their competitors, mostly being foreign competitors. I constantly hear from CFOs of many of those companies that they have trapped cash abroad, whether they are selling diapers, widgets, cylinders. Is that a function of our U.S. tax system today?

Mr. OOSTERHUIS. Absolutely. It is a function of the deferral system that requires foreign profits, which are taxed at a lower rate than the U.S.—and the U.S. has a very high rate relative to most countries—pay the U.S. incremental tax if they are distributed back to the U.S.

So even your U.K. profits—we are not talking about Irish-Dutch-sandwich-type profits—even U.K. profits that are taxed now at 23 percent, going down to 20 percent, with a 10 percent patent box, if a company brings those back, it has a huge tax cost. And it is not in your shareholders' interest that you bear that cost. Therefore, companies leave the money outside of the United States, and it is, in that sense, trapped. And that is an economic distortion.

Mr. TIBERI. So if we went to a pure worldwide system—we don't have that today because of deferral—wouldn't that also disadvantage those companies, those American worldwide companies that are selling diapers abroad, widgets abroad, cylinders abroad?

Mr. OOSTERHUIS. Going to a worldwide system, of current taxation of non-U.S. government, would be a huge gamble, because we would be risking the competitive life of our multinationals. No other country does it.

Ed gave some of the foreign tax rates. When you look at the averages these days that are effective, it is more like 17 percent. And so, even at a 25 percent U.S. rate, we would be subjecting our multinationals to a very large cost that their competitors, whether it is Samsung, Lenovo, Glaxo, Novartis, are not bearing. And their countries are not interested in forcing them to bear that cost.

Mr. TIBERI. So theory might be great, but, on the world stage, reality is different. And our companies that are selling diapers, widgets, and cylinders face a much different reality, right?

Mr. OOSTERHUIS. Correct.

Mr. TIBERI. So if we want to be competitive, because having a worldwide company in my district or in Mr. Reichert's district or Mr. Ryan's district, obviously, the best jobs of the company are usu-



ally at the headquarters—I know that is true in Columbus, Ohio—I have been told by CFOs that our current system that we are under, where that trapped cash is abroad and competitors don't have that double taxation, that when you have a merger or an acquisition, even if it is in a U.S. multinational company acquiring a foreign company, that for shareholders it is actually to the benefit to invert or move the headquarters to that foreign jurisdiction, whether it be Ireland or Belgium or another—

Mr. OOSTERHUIS. Right.

Mr. TIBERI [continuing]. Low-cost jurisdiction that might have a different tax system. Do you see that?

Mr. OOSTERHUIS. We see it fairly frequently. There are definitely transactions that are under consideration all the time involving U.S. companies and foreign companies combining. When you look at those transactions with our rules as they exist today, and even more so if we had Ed's proposed consolidated worldwide tax system, the only choice those companies have is for that resulting parent company to be a non-U.S. company. The difference in global tax liability of the complained company can be huge.

Mr. TIBERI. So we are really today, in reality, not in theory, in reality, we are at a disadvantage.

Mr. OOSTERHUIS. We are causing ourselves a disadvantage by the way our system works today. That is right.

Mr. TIBERI. Do you believe the Camp draft now, on the international side, by lowering that rate, will stop that disadvantage and maybe even potentially turn some heads internationally that, hey, you know what, not only should we not move but maybe we should actually look at the United States?

Mr. OOSTERHUIS. If you take the Camp proposal with option C, a variant of option C, you are certainly moving substantially in the right direction. Whether you get all the way there depends on the specifics of the base-erosion provision and some other aspects of it. But you would certainly move substantially in the right direction.

Mr. TIBERI. Thank you.

I yield back my time.

Chairman CAMP. All right, thank you.

Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I have been sitting on this committee listening to the fact that we need to reduce the tax rate to 25 percent on corporations, that that would make them competitive worldwide. And now today we come and we hear this. And it turns out that really what you want to do is bring back this so-called trapped capital back into this country.

Now, unfortunately, I have had the experience of sitting on this committee for quite some time, and I was here in 2004 when we repatriated. Eight hundred and forty-three companies repatriated, \$312 billion. They avoided \$92 billion worth of taxes. Fifty-eight companies accounted for 70 percent of that. They saved \$64 billion in taxes, and they laid off 600,000 workers. They paid dividends, and they bought bad stock.

Mr. MCDERMOTT. Now, I am trying to figure out, when you tell me that Apple and my local company, Starbucks, which we are

kind of proud of in Seattle, and a few other places are doing quite well but they got this trapped money over there, who is it that benefits from this untrapping? And what are they going to do? What benefit will there be to America?

Starbucks is doing pretty good right now. Apple is doing pretty good. All these companies are doing pretty good.

Mr. OOSTERHUIS. I will start out, Ed.

To my mind, it is largely their shareholders. I mean, I think with most companies—

Mr. MCDERMOTT. Oh, so it is the shareholders.

Mr. OOSTERHUIS. Yeah—

Mr. MCDERMOTT. It is not the workers. It is not the—

Mr. OOSTERHUIS. That is right.

Mr. MCDERMOTT [continuing]. Economy of the country. It is only the shareholders. Wherever the shareholders—

Mr. OOSTERHUIS. I think it is largely the shareholders, yes.

Mr. MCDERMOTT. Okay.

Mr. OOSTERHUIS. Because of a lot of that—there are two effects. One would be, if the money comes back, it would be used to buy back stock, pay dividends in the first instance that are not being paid now. And I think that is healthy. That gets the money efficiently invested, and that will help the economy.

The second aspect is that, today, because of the trapped cash, companies have more of an incentive to buy assets that are outside the United States than to buy assets inside the United States. It has to help us—

Mr. MCDERMOTT. Let me just stop you a second. Do you take into account at all those 600,000 workers who were displaced by that activity? Does that make any difference?

Mr. OOSTERHUIS. The workers weren't displaced by the cash coming back.

Mr. MCDERMOTT. Well, why was that part of the process? Why did they lay off 600,000 people in the United States when they are bringing all that money back here and supposedly investing it here? Tell me what that kind of investment looks like. Because if you don't hire workers, I don't see what the investment is. Maybe I don't—I am not an economist, so I, you know—

Mr. OOSTERHUIS. And I am not here to defend the 2004 Act provision that basically allowed companies to bring the money back and spend money that they were going to spend anyway and then do what they wanted to with the incremental money that they brought back. That is the way that provision worked. And so, in the end, most of the money ended up benefiting shareholders, not benefiting workers.

But that was the way Congress drafted the provision. It is not surprising that it worked as it was intended to work.

Mr. MCDERMOTT. So you would suggest maybe that we should put in provisions that would require them to invest it in things that produce jobs in this country, would you?

Mr. OOSTERHUIS. No. I think you should give companies discretion to do with it as they see best for their company. And that will give them a level playing field where they use the money or they distribute it to their shareholders for them to invest in other ventures which may well be in the United States.

Mr. MCDERMOTT. So with our own economy, we haven't done anything about poverty in this country. Poverty is about where it was. And we have 2 million people less working now than we did in 2007. And you don't think that anything we do in this tax structure should have anything to do with job creation?

Mr. OOSTERHUIS. I would not recommend enacting a provision that is targeted towards job creation. When I was on the Joint Committee staff back in the 1970s, when Mr. Rangel was the junior member, we drafted a credit for hiring in 1977. That didn't work very well. And those provisions generally tend not to work very well.

We really are better off setting up neutral rules for businessmen to make business decisions. And, hopefully, that kind of transparency and lack of economic distortion will lead to growth in the economy.

Mr. MCDERMOTT. Mr. Kleinbard.

Mr. KLEINBARD. I agree, actually, with a fair amount of what Paul said. Let me just—but a couple of important caveats.

First, \$100 billion a year is coming back right now. We have \$100 billion a year of repatriation today.

Second, the money is not trapped in the sense that it is excluded from the U.S. economy. The money is not buried in a backyard in Zug. The money is invested in U.S. banks and in U.S. Government bonds. So it is at work in the U.S. economy today.

Third, the U.S. multinationals that have this trapped cash have today the lowest cost of capital that they have ever had in a generation. They are not capital-constrained in any way.

Finally, where I do agree with Paul is, let the money come back as part of reform. Don't try to micromanage how the money is used. It will go for stock buy-backs. But tax the money, not at 5 percent, but at a higher rate. And use the tax revenues to fund programs that are designed to address joblessness, that are designed to address poverty.

Chairman CAMP. All right, thank you. Time has expired.

Mr. Reichert.

Mr. REICHERT. Thank you, Mr. Chairman.

Thank the witnesses for being here today.

I am fortunate enough to come from the same State as Mr. McDermott comes from. We have a number of international corporations, as you know, in Washington State that would be affected by these erosion proposals. And I have been following this base-erosion issue with a lot of interest, and it is not an easy thing to really grab on to if you are not some sort of a tax expert or a tax attorney.

But it seems to me like the goal here is to create a tax system where our companies are able to compete on a level playing field. And a couple of the ways that all three of you have mentioned today is to lower our tax rate and broaden the base. That is sort of a commonsense, I think logical approach which hopefully brings money back into the country and creates jobs, I think. But what I hear you saying, too, is to let the free market work. Don't micromanage, is what I have heard from all three of you also.

So what we all want, I think, Democrats and Republicans, is for our corporations to be competitive internationally and to pay the

taxes they owe. I mean, we have heard of companies that are not paying taxes right now.

So the testimony today, we have heard U.S. corporations that manufacture in foreign affiliates and then they sell the products back to the United States. And one of the main goals of the corporate tax reform is to put corporations on a level playing field, as I said.

How do our competitors, such as the U.K., who recently changed its international tax rules, handle these types of transactions?

Mr. SAINT-AMANS. Thank you, Congressman.

Over the past 10 years, just a fact for you, we have more than 10 OECD countries which have moved from a worldwide system to a territorial system. But at the same time they have, most of them—it is not the case of the U.K.—they have strengthened their CFC legislations to make sure that you tax territorial but you fight the de-localization of profits in low-tax jurisdictions or no-tax jurisdictions. The U.K. recently has lowered its corporate income tax but has also changed CFC legislation in a way which is not about strengthening it.

However, overall, the countries, I think, agree; there is a consensus, and it is clear at the OECD when we have discussions with all the member countries, that all the countries care about putting an end to the divorce between the location of the profit and the location of the activities.

Today, through the transfer pricing rules, the tax treaty rules, which were designed in a different environment, where business was not global—you had cross-border investment, but it was not completely global—these rules have not kept pace with the way business operates. And that is why we have gaps which allow businesses to put the profit in a shell company, where you have absolutely nothing else but funding and ownership with absolutely no employees to develop the intangible and the real value of the company.

And so the project that we are pushing for, which I think is fully in line with the reform you are trying to introduce, is to try to put an end to this situation which unlevels the playing field between companies within one country and also between companies from different countries.

Mr. REICHERT. So we have been talking about option C, which we know is not perfect but kind of gets us to that same point; is that correct?

Mr. OOSTERHUIS. Option C does have what I would call a destination focus, in that it taxes offshore manufacturing with respect to sales back to the U.S. at the full rate, but lesser so with offshore manufacturing for sales abroad. So it does have a destination focus.

Mr. REICHERT. Right.

Let me ask one quick question. My time is winding down.

One of the frequent questions that people have asked me about option C is, how do you define what percentage of income is attributable to intangible products?

Mr. KLEINBARD. This is one of the reasons why I think that option C, to sort of paraphrase Mr. Tiberi, have a theoretical merit but, as a practical matter, is impossible to administer. You are going to ask the IRS and companies to fight for the rest of their

lives about what fraction of total income is attributable to which intangible asset. I think that this is a very unfair burden to put on the future system.

Mr. OOSTERHUIS. I would, if I could, disagree with that, although there clearly is some burden. But if we define intangible profit as essentially being the excess profit over a routine profit, which is what the administration tries to do in their excess-profit proposed, that can be a relatively administrable proxy for intangible profits because you are taxing the rents that Ed talked about.

Chairman CAMP. All right. Time has expired.

Mr. Lewis is recognized.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Kleinbard, my district is home to a large number of corporations. Many of them are multinational and many more that are domestic. I strongly believe, in order for our American companies to grow, they must be competitive, both at home and abroad.

Now, the chairman has stated that he doesn't want a code that would pick winners and losers. In your testimony, you recognize there is something of a consensus around the idea of a hybrid system of taxation. If this system was adopted, would both domestic corporations and multinational corporations win? Who would lose?

Mr. KLEINBARD. In my view, corporations, multinational corporations, must come to recognize that in any future system, whether it is called worldwide consolidation, whether it is called territorial, whether it is called hybrid, any system that accomplishes the policy goals that you all share is going to be one in which U.S. multinationals pay a higher tax bill on their foreign income.

The only question is how much are they going to pay to the United States and how much are they going to pay to the countries in which they are really doing business. That is going to be a part of the revenue. How much is very hard to model, but it is going to be some of the revenue that gets you to the lower rate.

The lower rate is going to be really important because it enables the domestic business sector to be competitive in worldwide terms, which is what you really want. You want a U.S. environment that attracts foreign investments into the United States, and you want one in which U.S. firms that are U.S.-owned can, in turn, face tax rates that make their environment competitive with those around the world.

Multinational firms will pay a higher tax in the future. Whether it is a well-designed hybrid system with an option C that works—I have great skepticism about that—or whether it is worldwide, they will pay a higher tax to somebody.

Mr. LEWIS. Well, thank you very much.

Mr. Chairman, I yield back the remainder of my time to the gentleman from Texas, Mr. Doggett.

Chairman CAMP. All right.

Mr. DOGGETT. Mr. Kleinbard, there are millions and millions of dollars being spent to convince this Congress that the country will live happily ever after if it would just let these multinationals bring back their \$2 trillion from overseas and do wonderful things, fund infrastructure, do other things here in this country.

The last time we did that, as you mentioned, we entitled the bill the American Jobs Creation Act, but, as Mr. McDermott indicated, we lost 600,000 jobs.

You have pointed out in your testimony that much of this allegedly locked offshore tax revenue, locked offshore money, is actually sitting right here in the United States; it is only a paper transaction away. And that money can be invested in the United States in infrastructure or just about anything other than paying dividends, corporate executive raises, and buying back stock, can it not?

Mr. KLEINBARD. That is absolutely right, sir. The money is in the U.S. economy, it is at work in the U.S. economy. It is just in the one place where corporate executives really, really, really want it to be, which is in their—

Mr. DOGGETT. In their pockets.

Mr. KLEINBARD. In their pockets, yes, sir.

Mr. DOGGETT. Yes, in their pocket and in the pockets of some of their shareholders.

Mr. KLEINBARD. Yes, sir.

Mr. DOGGETT. But the money can be put to use now. What is really offshore is any payment of taxes.

And the notion that we would let folks get essentially a tax amnesty, pay a nickel on the dollar, without benefiting the United States economy as a whole and just enriching those who are already doing pretty well is a notion that strikes me as being very, very counterproductive.

Mr. KLEINBARD. And what is interesting, in addition, is this is the only time you will ever confront an efficient tax, in the technical economic sense. Taxing these old earnings does not affect future behavior. So, by putting a reasonable tax on the old earnings, you are not incurring any economic-efficiency cost. It would be the only time this committee has ever confronted an efficient tax.

Chairman CAMP. All right.

Mr. DOGGETT. Thank you very much.

Thank you, Mr. Lewis.

Chairman CAMP. Thank you.

Mr. Gerlach.

Mr. GERLACH. No questions. Thank you.

Chairman CAMP. Okay.

Mr. Buchanan.

Mr. BUCHANAN. Yeah, I want to thank the chairman for this important hearing, and I want to thank our witnesses for taking the time today.

Mr. Kleinbard, you had mentioned this idea, a worldwide tax. I don't want to oversimplify this thing, but I just look at these—these tax proposals and bills come up every 25, 30 years. You can see how far we have come in the last 25 years. I have done business abroad. I think about maybe we might not get to this for another 25 years.

But my point is, it seems like, to eliminate the trapped cash and all these other issues, isn't the bottom line really with all this is to have a worldwide tax, giving some consideration for territories and other things? But it has to be at the right rate.

I think of Hong Kong. When I was there 20 years ago, they had a flat rate, no deductions, minimal deductions, 20 percent. Back there a year ago, it was at 16.

Isn't really what we are talking about is that, you know, the U.S. and the world has changed in the last 20 years. Thinking forward another 20, 30 years—we want to be paid on taxes from around the world ideally. But it has to be at a number that is competitive and makes sense, takes the incentive away from CEOs to work with their accountants, outside accountants, creative tax lawyers.

So I look at this as someone who has done business abroad and thinking about this a lot. We need to get to a rate that makes sense. And I want you to comment. You have touched on that, but I want to go back. Isn't that really what we are talking about, ideally?

Mr. KLEINBARD. Mr. Buchanan, I would agree absolutely with everything that you have said. And to be clear, a worldwide tax consolidation, to move to that, part of that would be to deal with the trapped cash. Whatever you do, whatever you all decide to do for the future, you need to clean up the past.

Mr. BUCHANAN. We will deal. Let's make the assumption. I am worried about trapped cash in the future.

Mr. KLEINBARD. Yes.

Mr. BUCHANAN. We will figure out how to—

Mr. KLEINBARD. And the worldwide consolidation, as you say, does not have a trapped cash problem because you paid your tax on it already.

Mr. BUCHANAN. Yeah.

Mr. KLEINBARD. And I agree 100 percent that the only question really is rate.

Mr. BUCHANAN. And that is the question I want to ask you.

Mr. KLEINBARD. Right. And that is why I said in any testimony that my proposal only works if you imagine that the U.S. rate is squarely in the middle of the pack, ideally even a little bit lower than that, so that a U.S. firm can face in every country in which it does business a tax rate that is comparable to the domestic rate in those—

Mr. BUCHANAN. We have a 35 percent published rate.

Mr. KLEINBARD. And that is too high.

Mr. BUCHANAN. We effectively collect whatever, pick a number, 17 percent. But what do you think that number should be today? I am going to put you on the spot.

Mr. KLEINBARD. That is no problem. Twenty-five percent is, you know—my bid is 25 percent.

Mr. BUCHANAN. Okay.

Mr. KLEINBARD. And I would point out that there are a couple of countries, like the U.K., that are a little bit lower, others a little bit higher.

Mr. BUCHANAN. Personally, I think that is high. I know that is where we want to go as a committee, but—

Mr. KLEINBARD. We can negotiate.

Mr. BUCHANAN. Yeah.

Mr. Oosterhuis, I want to get your thoughts on this. I think, at the end of the day, the way we eliminate this stuff going forward, we have to have a rate that makes sense, that takes the incentive

away from corporations that do business worldwide, but what is your thought on that?

And then I want to put you on the spot. What should that rate be today so we don't have to game the system, somewhat game the system?

Mr. OOSTERHUIS. There is no question in my mind that 25 percent is definitely too high and risks the competitiveness of our companies over the long run.

Rates have come down in foreign countries since the study that Ed referred to, and many countries have patent boxes now that actually lower their rates from their statutory rates. The U.K. is implementing a 10 percent patent box. We are also facing more competition from Asian companies that are taxed at lower rates in their countries, as well as having their own territorial systems.

What rate would work? I think there are two aspects of that. One is, what is the rate? I mean, I would say for foreign income—for U.S. income, obviously we have to talk about maybe a 25 percent rate—

Mr. BUCHANAN. Yeah.

Mr. OOSTERHUIS [continuing]. Because that affects a huge amount of our tax bank. For foreign taxes, if we are going to eliminate deferral and have a current tax, like KFC does, but at a lower rate, I would say somewhere between 10 and 15 percent. But I would also say you would need to make sure you give a credit on an overall basis for the foreign taxes that companies are paying.

If you do that, then you will increase many companies,' the most successful U.S. companies,' taxes on their foreign income. You won't increase it on many companies that are not successful—

Mr. BUCHANAN. Let me add, just because my time is expiring, I think at the 25 percent rate—I don't want to take anything away from the committee or anything, but I think the bottom line, we will be back here again talking about the same things in the next 5 to 10 years. Because we are moving aggressively—95 percent of the marketplace is outside the U.S. We have to recognize that. That is the future. And we need to get to a rate that makes sense, and I think it is a lot lower than 25 percent to eliminate the gaming.

And I yield back.

Chairman CAMP. Thank you. Time has expired. And the chairman thanks the gentleman from Florida for not taking anything away from the committee.

Mr. Neal is recognized.

Mr. NEAL. Well, I hope my questions will add value to the conversation. Thank you, Mr. Chairman.

Professor Kleinbard, you have spoken of your concern with stateless income, income earned abroad that isn't taxed anywhere. So let me discuss with you, I want to ask you about something equally troubling, which is the stripping of U.S.-based income into tax havens to avoid U.S. tax.

As you know, for the past several years, I have introduced legislation to address a competitive imbalance in the domestic property casualty insurance market that favors foreign companies over their domestic competitors. I am not trying to hide the fact it is con-



stituent-driven. In fact, the legislation was developed working with your staff while you were the chief of staff at JCT.

A loophole in the current tax system allows foreign companies to strip their income overseas and avoid U.S. tax merely by reinsuring their U.S. written policies with affiliates located in tax havens. As you wrote in the last law review article, this provides them with, quote, “the ability to invest ‘long-tail’ P&C reserves in a tax-free environment.”

The ability to strip their earnings overseas and avoid U.S. tax on their investment income provides them with a significant advantage over their domestic competitors. Should our system favor foreign companies over domestic companies in serving the U.S. market, or should we restore a competitive balance by addressing this loophole?

Mr. KLEINBARD. You know, Mr. Neal, just because it is a constituent issue doesn’t mean that you are not right. And, you know, in this case—

Mr. NEAL. I just think I don’t want anybody to be confused about—

Mr. KLEINBARD. There is a policy problem here.

Mr. NEAL. There is a policy problem.

Mr. KLEINBARD. And the policy problem is, I think, unique to insurance. And the problem is that reinsurance is a kind of way of doing business in the United States without getting your fingerprints on the United States, so that you are treated as not doing business in the United States.

Reinsurance is a very interesting business. It is typically done by a long-term contract called a treaty. There is a season where everybody descends—literally, everyone goes to Bermuda for a 2-week period to negotiate their reinsurance treaties.

So it is possible to take on a great deal of insurance risk with respect to the United States without getting your fingerprints all over the U.S. tax system and being treated as doing business here in the United States by virtue of the unique nature of reinsurance. And so I do think there is a policy problem there that could fairly be addressed.

Mr. NEAL. Okay.

I am pleased you raised the issue of Bermuda because Members of the Committee that have been here for a long time, you know I tackled that issue back in the early 1990s and had some success. But the former chairman of the committee resisted the idea of making the provision retroactive that we offered, and we were able to shut it down, only to discover that on the island of Bermuda today there are still plenty of companies that insist that they are a Bermuda-based company without economic substance.

It is a real issue.

Mr. KLEINBARD. Yes, sir. I believe it—I agree. And it is unique to reinsurance because of this whole idea of the reinsurance treaty and the very short time period in which the treaties are negotiated enables U.S. risk to be taken on by firms without being technically treated as doing business in the United States.

Mr. NEAL. Right.

And I had some success in leading the charge here on FATCA, as well. But I want to, based on what you have just said, Professor

Kleinbard—I recently talked to Tom Barthold and his team at JCT about a difference between tax avoidance and tax evasion.

As the former head of JCT, would you talk to me a bit about the differences between these two concepts?

Mr. KLEINBARD. Yeah. I am obviously going to talk in my capacity as a professor of law. I have nothing special to say about JCT and its work in this respect.

When it comes to corporate tax, when we talk about the kind of issues we are confronting today, I like to think of things in terms of a continuum of aggressiveness of behavior rather than avoidance and evasion. I, frankly, don't find those terms as helpful.

The basic problem is that, anytime you have fact-intensive issues, there is a mismatch between the corporate taxpayer and the tax authority. The corporate taxpayer can muster more resources, knows itself better, obviously, and can put more energy into a case.

And so the systems that, unless they are very simple—this is one of the reasons I like worldwide tax consolidation—unless the system is very simple, you are always going to have a mismatch in the energies that are brought to bear on a question between an aggressive firm and the IRS. That rewards aggressiveness in behavior. And, as I say, I think of it as a continuum, but I think the right word is “aggressiveness” and how aggressive is a firm.

Today, firms really are, you know, self-reporting agencies. We rely very heavily on corporations to get it right in the first instance. You don't want a system that encourages more and more aggressive behavior.

Chairman CAMP. All right. Thank you.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

And thank you to our witnesses for sharing your insights and expertise.

We know that the world economy and global economy is very diverse, and manufacturing might be very different from, say, agriculture, which I represent.

Could you perhaps share your perspective on how the current U.S. tax system affects American agricultural producers internationally and what the effects of changes proposed in the chairman's discussion draft would be on those?

Mr. KLEINBARD. You know, I was in private practice for a long time, but I didn't have any direct experience with agricultural exporters.

But I think the fundamental point is they ought to be concerned with rate, and anything that gets to a lower domestic rate is going to be in their long-term interests. And I think we have a consensus among the three of us that the U.S. statutory rate today is too high, and domestic business, including export business, is disadvantaged.

Mr. SMITH. Thank you.

Mr. OOSTERHUIS. Yeah, I would agree with Ed on that. I think, you know, we do have agricultural companies that are global. I seriously doubt that any of them would be accused of base erosion, because their products are commodities, and so transfer pricing

ing works relatively well in that world. But they do engage in tax planning, like other U.S. multinationals do and as they should.

And so I think, for some of those companies, the kinds of reforms that we are talking about today that would be a hybrid system of exemption and current taxation and get rid of the potential trapped-cash problem would be a constructive reform for those companies, as well.

Mr. SMITH. Okay. Thank you.

Any others wish to comment?

As well, what would you say is the experience of other countries who pursued repatriation alongside a shift away from worldwide to territorial, hybrid, or another system?

Mr. SAINT-AMANS. I am not sure that other countries have been in the same situation as the U.S. I think it is a very typical U.S. situation because of the articulation of the very high rate, the check the box, and all the very U.S.-specific features. So, to my knowledge, it has not arisen in other countries in the same terms.

Mr. SMITH. Okay.

Anyone else?

Mr. OOSTERHUIS. Well, I can speak somewhat, at least, for the U.K. I mean, I think the U.K. has not only lowered their corporate tax rates and gone to territorial, but they actually limited their CFC rules in terms of their application to U.K. multinationals with respect to their non-U.K. income. And I think that has been a healthy thing for their multinationals.

And now the U.K. is a jurisdiction that is attracting companies. I mean, when we have a U.S. company that is combining with a non-U.S. company and the CEOs ask, where do we put the headquarters of this company, the U.K. is at the top of the list.

Mr. SMITH. Uh-huh.

Mr. KLEINBARD. Yeah, just with respect to trapped cash, we really need to distinguish the past and future. In the future, there will be no trapped cash. Whatever this committee does will not replicate the bizarreness of the current system in that respect. So the problem with trapped cash is entirely a problem with respect to the past.

And there, again, we have to remember, the reason why we have \$2 trillion of trapped cash is that firms are hoist by their own petard. They have been so successful at stateless income generation, they have so much income that has been taxed at 5 percent or less effective rates, those aren't competitive rates. There are no countries in which firms actually do business that have 5 percent rates.

Those are the results of aggressive tax planning. And that success at achieving extremely low effective tax rates creates the problem and explains the \$2 trillion.

Again, this is the only time, I believe, that this committee, at least in my lifetime, will ever confront an efficient tax, a tax that is efficient. It is efficient in the sense that it does not have any adverse behavioral consequences. There is no reason why the old cash should come back at preferential rates. The old cash should come back at a sufficient rate to pay for reform, because going forward you will have moved into a new system with completely different behavioral consequences.

Mr. SMITH. Thank you.

And I yield back.  
Chairman CAMP. Thank you.

Mr. BECERRA.  
Mr. BECERRA. Thank you, Mr. Chairman.  
And thank you to all of you.

And, Mr. Kleinbard, great to see you here. I hope you don't penalize us for our weather here. I know you are going to head back to sunny southern California, and I plan to join you soon. But just wait a minute, the weather will change.

A couple of quick points.

First, Mr. Kleinbard, I think you mentioned that, while I think there is full agreement throughout the room here that the system for taxation for all of our business community, whether foreign or domestic, has problems.

Can you focus a bit on the domestic issue that we have with our corporate tax system, or business tax system—not just corporations, for all our businesses?

Mr. KLEINBARD. Yes. I think we have two structural issues in the United States. The first is that the U.S. is the only large economy where a large fraction of its business income is outside the corporate sector. That is unique to the United States. More than half of our income now, business income, is earned by unincorporated businesses. Some are small, but some are also very large.

Second, we have the worst of all worlds; we have a high statutory rate with sort of middle-of-the-pack effective rates of what we actually collect. Those statutory rates leads to all sorts of tax avoidance behavior, tax planning work that people, you know, like in my former life, Paul—you know, we should all be put out of business. And, at the margin, it distorts marginal decision-making.

So it is really important to get a lower rate. That makes the U.S.—corporate rate. That gets the U.S. economy to be more efficient. It leads to a better allocation of resources, and it leads to more investment in the United States. And, again, it is not just U.S. people investing in the United States. It also makes the U.S. a more attractive environment for foreign investment to come into the United States.

Mr. BECERRA. And most of the discussion we have had today deals with our treatment of foreign-earned income by corporations.

Mr. KLEINBARD. That is right, sir.

Mr. BECERRA. But if I recall correctly a statistic from the Small Business Administration, 99 percent—actually, 99.7 percent, I believe they say, of all employer firms in this country are small businesses that are unlikely to be corporations, or at least corporations that do business abroad and have a large percentage of their income coming from foreign activities.

Mr. KLEINBARD. The second part is almost certainly true. The first part is going to pose a very interesting question. When you lower the corporate rate, when you clean up the corporate preferences and create a more attractive business environment, what will unincorporated businesses do?

Mr. BECERRA. Right. So 99.7 percent of all the companies, of our firms in America really aren't going to benefit directly, immediately, from something we do with the foreign-earned income. They may ultimately and indirectly; I think there is no doubt about

that. Because what affects AT&T or some multinational company will obviously affect those small firms that do business with AT&T.

But when we talk about the taxation of foreign-earned income, we are essentially not talking to about 99.7 percent of the companies and firms that are here in the U.S. And I think we have to recognize that they have a great interest in having a workable tax system, as well. And so we have to recall that all those businesses today that are hiring Americans are likely not part of the conversation we are having with regard to foreign-earned income.

Can I move to another subject, and that is this whole issue between worldwide versus territorial rates for the treatment of foreign-earned income. I always am amused by those who talk about us accepting the territorial treatment of foreign-earned income. But folks put the period after talking about the territorial rate that a country uses for treatment of that income by those companies based in those countries.

I am wondering if those who advocate for territorial tax rates for multinationals would argue that the U.S. should adopt the rest of the tax system or regime used by those countries that have a territorial rate. And so I did a quick little Googling with looking at Wikipedia.

And, Mr. Oosterhuis, to respond to some of the companies that you mentioned, you mentioned Nestle. I got Nestle, Novartis, Glaxo, Lenovo, Samsung.

Glaxo is based in the U.K. Their tax revenue as a percentage of GDP is 34.3 percent. They are collecting more tax revenue than we are. The U.S., the OECD looks at us as having 24 percent.

So the U.K. collects more in taxation than the U.S. does. If we go to a territorial rate, which reduces rates for companies, someone is going to have to make up for that. And what the U.K. does is they make up for it with income taxes, national insurance, VAT tax. And I am wondering if—

Chairman CAMP. All right.

Mr. BECERRA [continuing]. We would be prepared to accept all those other tax regimes along with a territorial rate, when we talk about a territorial rate.

So that is food for thought. Maybe at some point, Mr. Chairman, we will have an opportunity to discuss that.

Chairman CAMP. Time has expired.

Mr. BECERRA. Yield back.

Chairman CAMP. Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman.

Thank you all for being here.

The OECD report calls for a renewed focus on risk allocation. According to the report, the transfer pricing guidelines are perceived by some as putting too much emphasis on legal structures, for example, in contractual risk allocations rather than on the underlying economic reality.

Some have proposed moving away from the principle that risk may be allocated among entities by contract and towards the principle that significant people and functions are determinative in allocating profits.

One potential downside is allowing countries to recharacterize transactions based on some sort of economic substance claim and,

as a result, could very well create an incentive to move people and jobs offshore to low-tax jurisdictions.

So for all of you, in your view, are there specific areas where the current guidelines produce undesirable results from a policy perspective? And do the current OECD transfer pricing guidelines place too much emphasis on contractual risk allocations rather than the underlying reality of an economically integrated group?

Mr. Saint-Amans.

Mr. SAINT-AMANS. Thank you, madam.

In the area of high-risk activities or highly mobile activities or intangibles—and we all know that the value now is—I mean, the value chain, the value is in the intangibles. The transfer pricing guidelines can be put at jeopardy or are failing in a number of circumstances.

And it can be serious, because what businesses need is security. I mean, they need to know—they need certainty. They need to know what the tax regime will be. And if a number of countries depart from the international consensus there, the risk we face is that they will take their own measures, they will take their own interpretation, and this will be chaos for business.

So what we are trying to do is to recognize the difficulties of the arm's-length principle, which too much relies on some legal arrangements in the activities you have precisely described, to tackle this and make sure that if you have in a very low-tax jurisdiction two men and a dog to deal with all the intangibles of a highly sophisticated multinational, whether American or European or from Asia, this would not work. And all the profits cannot be located without regard to where the intangible has been developed.

So this is part of the action plan that we are developing. But, again, this is to protect the consensus and to keep the certainty for all the players, tax administrations but also companies.

Ms. JENKINS. Thank you.

Mr. KLEINBARD. I do think that a fundamental problem with current concepts of transfer pricing and of the exploitation of intangibles is the empty formalism that we allow to drive results. This is how we get to stateless income. It is by treating as real contracts between a company and a subsidiary, where that subsidiary is nothing but the alter ego, in practical economic terms, of the parent itself.

Looking forward, the OECD discussion draft changes the calculus. It says, if you want to be treated as the owner of an intangible, you really have to have independent business substance, you have to be the one that does the R&D, the subsidiary does, itself. And I think that is the right answer.

I appreciate the concern that that means that tens of thousands of high-priced engineers will now move to the Cayman Islands, but I also appreciate that, in reality, that won't happen. You know, I spent years trying to get securities traders to move across the river to New Jersey. I couldn't get that to happen.

Mr. CROWLEY. Thank God.

Sorry, Mr. Chairman.

Mr. KLEINBARD. With all respect to New Jersey. It is just how they work.

So the problem is a very serious one.

We actually have in the code, in 954(h), we have today a rule that requires that. Oddly enough, it is for banking income. And banking income is not the source of all the problems that we talk about, because the rules require the human carrying-out of all the relevant human activities by the CFC itself.

Mr. OOSTERHUIS. Could I—

Chairman CAMP. Just briefly.

Mr. OOSTERHUIS. Yes.

I disagree with Ed on a portion of this. If we are not going to recognize where expenses are incurred, then we are moving away from arm's-length pricing, and we should just be candid about that. Because, in the real business world, who is bearing expenses is one of the most important determinants of who gets the income.

And, yes, from a group point of view, that fact that one entity is bearing it at the Irish tax rate rather than another entity is bearing it at the U.S. tax rate and it is being deducted in one country versus another, that from a group point of view doesn't matter that much, but from a country point of view it does.

If we want to move away from that, what we are moving to is what you might call a factor apportionment system, where you are allocating the income based on factors. And if you have the income allocable to where the jobs are, you are going to have some of those jobs move over a 20-year period when you have this in place. That is just going to happen. It may not happen overnight. You are not going to pick up 80,000 engineers and move them overnight. It is not going to be a giant sucking sound. But it will happen. And you have to be careful.

And that is why in my paper I suggest, if we want to move away from arms-length pricing, that we move towards more of a destination-based income tax, where the intangible value is allocated to where the sales are, because the sales are not movable. The sales are the least movable aspect of economic activity.

Chairman CAMP. All right. Thank you.

Mr. Doggett.

Mr. DOGGETT. Thank you very much, Mr. Chairman.

And thanks to our witnesses.

I certainly take the same pride other Members do in the creativity and product development and the success of large American companies. We have many of them with major operations in central Texas, and we are glad to have them there.

But I think we can applaud and encourage that success without maintaining a view that, because they are successful and they are big names, they are entitled to special treatment in the Tax Code not accorded to other businesses and individuals.

The real question today about all of the fine print and complicated discussion that we have had is whether or not small businesses and individuals ought to bear a greater part of the tax burden so that some of these large, brand-name multinationals can pay less.

I like a good cup of Starbucks just like the next person, but I also enjoy my coffee when I get a chorizo plate at Joe's Bakery or when I have a breakfast taco at Patty's Taco House in San Antonio or when I go by and pick up my cleaning at Estrada Cleaners. And

those companies, those small businesses, they don't get the kind of tax breaks that are available for these multinationals.

And a system that accords General Electric a lower tax rate than the people that clean up the corporate board room at General Electric I think is really offensive. What we have here is massive tax abuse, outrageous tax abuse by large, multinational companies.

And I think the second major question before us today, amidst all the minutia, is whether or not we want a Tax Code that encourages the export of American jobs overseas. If we have a system that says to a company that is looking to invest in either San Antonio, Texas, or South Africa or Europe or Asia that if they invest abroad they will pay nothing on the earnings from that investment but if they invest here they will pay 20, 25 percent, even 10 or 15 percent, the incentive is to encourage the export of those jobs overseas.

And I think another question before the committee is whether the problem is just with the laws or with the companies, as was suggested in the opening remarks. As if the two didn't have something to do with one another.

Thirty companies have paid more to their lobbyists than to the United States Treasury in taxes. And I think they made a pretty thoughtful investment, because when you look at this Tax Code, it didn't just come down on tablets. It was the result of the determined lobbying efforts by some of the same companies that are here today asking for tax reform to make our system more complex if it helped them to maintain the minuscule level of taxes that they were already paying.

Indeed, this committee and the Senate Finance Committee, if anything, facilitated, enabled, and created that Tax Code. And but for the work of the Permanent Subcommittee on Investigations under Chairman Carl Levin and some impressive investigative journalism from several journalists, we would not even know about the extent of the abuse that is occurring in America today and shifting that burden to individuals.

Mr. Kleinbard, as I listened to Mr. Oosterhuis, or really read his testimony, I got the impression that if we had more cost-sharing agreements, like the one Apple has, that we would be better off. As I understood the testimony before the Senate Investigations Subcommittee, Apple developed, I guess with the research and development tax credit, products here that it assigned 60 percent of the rights to Irish companies. And on \$74 billion of income, it assigned that to the Irish subsidiary, with profits taxed at less than 1 percent.

Do we need more cost-sharing agreements like that?

Mr. KLEINBARD. Paul and I obviously part company quite dramatically on this point. I do not see cost-sharing agreements as a solution. I see them as a core part of the problem.

Again, when you look at the international tax questions, there really should be a tug of war in your mind between the United States as the residence country, as the place where, say, intangibles are primarily created for a U.S. firm on the one hand, and the market country on the other, where those intangibles are exploited, where the products are sold. Who gets how much; it is a tug of war.

What the cost-sharing agreements as currently practiced do is siphon money off between the two legitimate claimants, between the



home country and the market country, to nowhere. That is why I called it stateless income. That is what Apple demonstrates. That is not income that reflects doing business in Ireland or anywhere else. The income that is being taxed under the cost-sharing agreement at essentially close to zero rates is income that has been syphoned off either from the United States, which I think is the case in that particular example, or from the market country.

So, unless you radically change how cost-sharing agreements work, along the lines of what the OECD has actually proposed, which is to require a firm, before it could even claim that it is part of a cost-sharing agreement, to do all of the work, as opposed to just contract right back to the U.S. parent to do the work, it is a meaningless operation. It is a subsidiary that purports to take on risk.

That is no risk-shifting. The parent ultimately bears all the risk because it owns the subsidiary. There is no risk-shifting going on, there is no independent decision-making going on, and there is no independent ability to act going on.

Mr. TIBERI [presiding]. The gentleman's time has expired.

Mr. DOGGETT. Thank you.

Mr. TIBERI. Mr. Marchant is recognized for 5 minutes.

Mr. MARCHANT. Thank you, Mr. Chairman.

A question for Mr. Saint-Amans: Can you describe to us the trends in the OECD countries on corporate tax rates since the U.S. lowered the corporate tax rate as a part of its last big tax reform in 1986?

Mr. SAINT-AMANS. Thank you, sir.

Indeed, the U.S. and the U.K. in the mid-1980s started the trend of reducing corporate income tax rates. And this trend has been pursued by almost all OECD countries except the U.S., which now has the highest rate. The average rate in the OECD is around 24 percent for corporate income tax. The U.S. is at 35, plus the State taxes, so the average is around 39 percent in the U.S.

There is a distinction between small, open economies and bigger, less open economies, and usually the rates in bigger economies will be higher than in the small, open economies. If you take Germany, you are at around 30 percent. France is at 34 percent. But, still, the trend has been to reduce the rates in all OECD countries. And Japan, which was quite high, higher than the U.S., has recently, last year, changed its rate to reduce it.

Mr. MARCHANT. And of the OECD countries that have the lower rates, do all of them have a VAT tax, as well? Or is the U.S. the only—

Mr. SAINT-AMANS. The U.S. is the only OECD member country not having a VAT system.

Mr. MARCHANT. So if you take the complete tax picture into account in each of these countries, is there still a very large gap between the actual tax bill of the companies versus just simply the corporate tax bill?

Mr. SAINT-AMANS. This would assume that VAT is borne by companies, where, from an economic perspective, it is more borne by the ultimate taxpayers, who are the consumers. So I am not sure we can bundle both corporate income tax and VAT.

Mr. MARCHANT. Okay. So any comparisons throwing the VAT in distorts that whole equation, in your view.

Mr. SAINT-AMANS. Indeed.

Mr. MARCHANT. The U.S. worldwide system taxes U.S. tax-based companies on the profit of their foreign subsidiaries. Most of our major trading partners exempt that kind of income.

If the U.S. converted to a pure worldwide system, wouldn't that provide a tax incentive for foreign companies to buy U.S. companies?

And that is a question for all the panel.

Mr. SAINT-AMANS. I can start by providing the following response.

You have no pure system, or it is quite exceptional. I mean, Hong Kong, which was referred to earlier, has a pure territorial system, but it is quite exceptional. But in most of the European countries or Asian countries, Korea, Japan, when they have a territorial system, it is a territorial system with teeth, which means that you will be taxing some of the profits made offshore when they are taxed at a very low rate.

And when you have a worldwide system, as you have here in the U.S., you have exceptions, which allows, actually, companies not to pay their taxes because of deferral or because of other mechanisms not to pay.

So you have hybridity almost everywhere, and so you have no such thing as a pure system. So what matters, I think, is the way you will design either of the systems you can opt for.

Mr. MARCHANT. Mr. Oosterhuis.

Mr. OOSTERHUIS. But it is absolutely true that if we went to a worldwide system—and, indeed, today, with our deferral system, compared to the system in countries like the U.K., like the Netherlands, like Switzerland, when deals are thinking about being done, when companies are thinking about combining, and they are incorporated in different countries, it is rare for them to think of using a U.S. company as a parent. And that is because it would subject the earnings of the non-U.S. company to the U.S. tax regime, overlaid on their own tax regime. And that would clearly be a detriment to the synergies that the transaction is intending to accomplish.

Mr. MARCHANT. Mr. Kleinbard.

Mr. KLEINBARD. The problem is, what Paul said about current law and current business practice is true, but the question is, how will people behave in the new regime? If you have a worldwide tax consolidation with a low rate, then the incentive to be not the U.S. corporation would dissipate. So we really have to project forward to a different regime to answer that question appropriately.

Mr. TIBERI. The gentleman's time has expired.

Mr. Blumenauer is recognized for 5 minutes.

Mr. BLUMENAUER. Thank you.

Mr. Kleinbard, I would like to explore one element here. We have had reference to how individual countries would like to have tax advantage for their own enterprises, a little home field advantage, or maybe a lot of home field advantage, with patent box or whatever.

But I wondered if you could just take a step back and help us visualize, what would be the dynamic for countries across the board if we could have some mechanism that agreed to a 20 percent rate, a 25 percent rate, a uniform rate? Is it conceivable that the top 10 economies of the world, where most of the business is being transacted right now, that they would end up substantially ahead?

Mr. KLEINBARD. A couple quick thoughts.

For 100 years or so, we had this problem in the world of trade, where countries tried to get a leg up through trade subsidies. And, finally, countries wised up, and we have GATT today, the General Agreement on Trades and Tariffs, and countries act together. Ultimately, what is going on right now, I think, in countries like the U.K. is, in effect, a trade war being conducted through the guise of the tax system. And that is unhealthy.

But the truth is that, if you look at the OECD data, corporate rates from major economies, in fact, converge towards a point, and that point is in the neighborhood of 24 or 25 percent. So European countries, in particular, have gigantic revenue problems, they have deficits, they have all the same problems the United States does in that respect but more so. A 24 or 25 percent rate is more or less the norm, without the formality of a GATT-type process.

And that, I think, is a much healthier environment for everyone to be in, is the comparable rates across the board, and then firms make their decisions based on pure business considerations.

Mr. BLUMENAUER. But the issue that I am wrestling with, everybody ought to be concerned about income that doesn't have a home, that simply there is no tax liability. And as you pointed out, if Starbucks can figure out a way to do this, anybody can. Although Starbucks found a way to classify pouring coffee as being manufacturing, and they ended up getting a \$88 million tax break in 2005.

But isn't everybody going to be facing this, ultimately? That, unless we reach some sort of accord, people are going to gravitate, because they can, putting aside the morality of it, or if they have a fiduciary responsibility, they are going to do it if they make a substantial amount of money.

Mr. KLEINBARD. Yes. And that is what the OECD is all about. I mean, the OECD is the best organization today to try to get the consensus on the kind of issues you are concerned with.

Mr. BLUMENAUER. Well, is there a way to formalize some of this, in your judgment, in the context of treaty negotiations moving forward?

Mr. KLEINBARD. Yes, absolutely. We have exactly that experience in the trade area with GATT, with the General Agreement on Trades and Tariffs. So we have experience in this area.

Mr. SAINT-AMANS. If I may, shortly, one of the challenges in the tax area is that tax is at the core of sovereignty. And this cannot be overcome anywhere, and so be it.

And so what we are trying to do as the OECD is to get the countries to speak to each other so that they respect their sovereignty, but there is some form of leveling the playing field on the one hand, and on the other hand limiting the frictions in terms of double taxation, but also limiting the gaps in terms of double nontaxation.

And that is why we bring all these countries, which are sovereign at the end of the day—they will decide for themselves, but they cannot ignore the spillover effects on the others. And bringing them together is a way to limit such risks.

Mr. BLUMENAUER. Thank you very much.

Thank you, Mr. Chairman. I hope that this is the beginning of a series of hearings, that we can do a deeper dive on this. I have enjoyed the informal operations that we had with the working groups, but I think there is value to the committee to continue this. And I hope this is the first of several.

Mr. TIBERI. Thank you.

Mr. Reed is recognized for 5 minutes.

Mr. REED. Thank you, Mr. Chairman.

And, to the panel, I really do appreciate your input and information on this.

And I heard at least some unanimous kind of positions that were being taken, and one is that we need to do something, that maintaining the status quo doesn't work. And that is good.

I also kind of got a sense of, when we were talking in response to my colleague from Washington, Mr. McDermott, that when we looked at the repatriation holiday history—and one of the lessons I am taking away from that, having not been here, was that, if you do it on a temporary basis, you are going to get different behavioral outcomes as opposed to if you do it on a permanent basis.

Mr. REED. So I think I got a sense that there is a broad agreement to do it on a permanent basis versus a temporary basis.

The one thing that I am very interested in exploring a little in detail with you is, I firmly believe in the innovation economy, but I also believe that we can have a manufacturing renaissance here in America again. I am the eternal optimist, and I believe it can happen, though. And so we will continue to work for it.

So as we look at option C from the chairman, Mr. Oosterhuis, I would be interested in, how do you see option C promoting manufacturing in America? And give us some input on that, and then we will—

Mr. OOSTERHUIS. Sure.

Mr. REED [continuing]. Maybe open it up to other portions of the panel.

Mr. OOSTERHUIS. What option C does is, by providing a lower tax rate on the intellectual-property element of value in exported products, option C allows exported products then to bear an aggregate tax rate that is similar to foreign-manufactured products. So it levels the playing field between U.S. and foreign manufacturing.

Now, it does it by giving a deduction for a portion of the IP profit. There are other ways you can do that, I think, and there may be some ways that would raise fewer trade concerns than what Camp option C has.

But the point is that Camp option C says, we are not going to go to a 25 percent tax rate on the foreign manufacturing for foreign markets because that has a serious competitive impact on U.S. companies. And, instead, given that, if we are going to tax at a lower rate, then we want to also reduce the tax on exports so that U.S. factories can compete with offshore manufacturing. And

that would be an improvement over the situation that we have today.

Mr. REED. Mr. Saint-Amans, do you agree or disagree with Mr. Oosterhuis' assessment on that? And if so, why or why not?

Mr. SAINT-AMANS. It is hard for me to meddle in the domestic debates between the options. So I don't really have a comment, except the general comment that you have no pure system such as a worldwide system or a territorial system.

So it is up to the U.S. to decide which one you would like to take, knowing that intangibles clearly are where the value now is located in the value chain, and many countries are introducing patent boxes. That is just a fact that I can bring to you, the U.K. being the latest one having introduced such a patent box. The Netherlands has done so recently. Switzerland has a plan to do this.

It doesn't mean that it is the right way to follow because it has some implications also in terms of tax competition. Within Europe, there is a debate on whether a patent box is a right thing to do also.

But I have no personal nor official view to share here with you.

Mr. REED. Well, I appreciate you dodging that one.

Mr. Kleinbard.

Mr. KLEINBARD. You know, we do have today an incentive for manufacturing in Section 199. We do have a special tax rate for domestic manufacturing.

You know, I would love to see a renaissance of domestic manufacturing. That is why I think reducing the tax rate to 25 percent for the broader base is really an urgent priority. It will bring foreign investment into the United States, among other things, which we tend to forget about.

But I don't like trying to pick winners or losers. And I don't think that the tax system should be designed with the premise that we are going to subsidize in some way one sector of the economy as opposed to another. Let's get an efficient tax and get tax out of the business of businesspeople and let them get about their business.

Mr. REED. Well, and I appreciate that input. So we have another general sense of agreement. Lowering the rate will bring that opportunity for manufacturing here in America.

And I see my time is expiring, so I guess, with that, I will yield back, Mr. Chairman.

Mr. TIBERI. The gentleman from Wisconsin, Mr. Kind, is recognized for 5 minutes.

Mr. KIND. Thank you, Mr. Chairman.

This has been a very enlightening hearing. I want to thank our witnesses for your insightful testimony today.

Mr. Kleinbard, just picking up on the last point, because I do share my friend's focus on domestic manufacturing—and this is true for all the panelists who want to weigh in on it.

I am assuming that, implicitly, because you haven't addressed it in your written testimony or even today, that there should be no distinction between tradeable and nontradeable jobs when it comes to comprehensive tax reform or the impact on the domestic manufacturing base?

Mr. KLEINBARD. I start from the premise that we want to have a neutral business environment in which firms face a consistent

tax rate and then let business go at it. So I don't make any distinction between the two.

Mr. KIND. Well, let me ask you this, then. Obviously, any formal revenue collection system is meant to basically fund the basic government functions. And the reason this is so hard is we are trying to avoid blowing another hole in our budget deficit. So the goal of trying to reduce the rates and simplify and broaden the base has to be paid for. And that is what is so difficult, and why we don't have a plan on paper.

And here is my concern. And I have been wrestling with this in regards to the territoriality and the impact in that, is we always seem to be playing catch-up internationally, with the OECD nations, what they have done in the last decade or so in lowering their corporate tax rate. But they have been in a unique position of being able to dial up their VAT in response to a reduction in revenue on the corporate side. We don't have that option. And so we are going to have to look at expenditures within the Tax Code in order to eliminate, in order to pay for the reduction somewhere else.

And many of those expenditures, on the C side especially, have a direct impact on domestic manufacturing. The 199, Mr. Kleinbard, you just cited, depreciation, R&D—those are the big ones. And so, if we are going to get to a 25 level, chances are we are going to have to go after them.

Mr. KLEINBARD. Yes, sir. I think that that is correct, Mr. Kind.

Mr. KIND. Yeah. And do you think we have been operating somewhat in a vacuum by ignoring the VAT system that exists in virtually every other OECD nation?

Mr. SAINT-AMANS, I have noticed that their ability to reduce the corporate rate has also been coupled with their ability to dial up the VAT too.

Mr. SAINT-AMANS. Thank you, sir.

I am not sure I would venture on the area of VAT, which is quite controversial, I understand, in this country.

However, I would like to draw your attention to the fact that, in spite of having reduced the rates of corporate income tax over the past 20 years, OECD member countries have seen the contribution of corporate income tax to the overall revenue increasing. So it doesn't—

Mr. KIND. Is that based on the corporate rate or all the taxes?

Mr. SAINT-AMANS. On the corporate rate. I mean, the corporate income tax contribution to the overall revenue has increased instead of diminishing, which results in some saying there is no base erosion and profit-shifting; look, the rates have reduced, but the contribution has augmented. Actually, it should have augmented further if you take into account the profitability of companies.

And, of course, you have cycles there. Following the crisis in 2008, you had a decrease. But, overall, you can find a tax policy reform which will be neutral or which can even bring more money to the revenue. So decoupling it from the—

Mr. KIND. And how much of that do you attribute to the teeth that they put into the territorial system that they have moved to?

Mr. SAINT-AMANS. That is quite hard to interpret, so I wouldn't get into the details.

Mr. KIND. Okay.

Mr. SAINT-AMANS. But I think it is worth looking at it. The data is available to you, of course. This is official from the OECD.

Mr. KIND. Right.

Well, I just think, you know—and, again, I would be interested in following up with you—that we do need to be somewhat careful in regards to the incentives that already exist for domestic manufacturing in the country, since those are the big ones that we are really going to have to wrestle with if we are going to be able to lower the rate to a level that makes us competitive globally.

And I think these companies are going to have to do their calculation, whether they can live with a simplified lower rate without the current expenditures that they are able to take advantage of. And I think right now, when we are trying to create more jobs domestically, I think there are important distinctions to be made between the tradeable and nontradeable jobs that we see going on in the global economy.

Mr. KLEINBARD. Mr. Kind, one thing to sort of keep in mind here is that the United States is, in 2012, the lowest-taxed country in the OECD. There is capacity in our economy to raise more tax.

But, also, when you think about taxes and burdens on individuals and burdens on businesses, you have to remember how does the government spend the money. And other countries raise more tax, but they then spend that money in much more progressive ways.

Mr. KIND. Well, and, again, that is one of the great elephants in the room here, is we do as a Nation have the obligation of financing the world's largest, most effective military that does provide a relatively stable and peaceful global market for companies to do business. No other nation is willing to step up to assume that obligation, so we have to wrestle with that obligation, too.

Thank you.

Mr. TIBERI. The gentleman from Indiana is recognized for 5 minutes, Mr. Young.

Mr. YOUNG. Thank you, Mr. Chairman.

I thank all our panelists for being here today, offering your thoughts. It has certainly been a thought-provoking conversation with some divergent views on different things, and I think that is helpful in a public forum here.

Mr. Saint-Amans, I have also appreciated your very much understandable efforts to try and avoid making much international news in your current capacity.

You know, one of the benefits to being of lower rank within this committee is that I have an opportunity to sometimes respond to some earlier comments that were made and get clarifications, and I would like to do that.

First, it will just be a comment. There was earlier a statement made with respect to small businesses, saying that there seemed to be a desire among some to have small businesses pay more so that multinationals could pay less in this effort. And, certainly, I don't share that. And for those that have those concerns, I think it is really important that in this country, in the interest of com-

petitiveness internationally and domestically, we reform not just the corporate code but also the individual code.

But, secondly, I would like to talk about an exchange that was earlier made—I think, Mr. Kleinbard, it was directed towards you—related to the benefits of repatriating profits. I think it is actually, again, thought-provoking that so much of those moneys that have not been repatriated are essentially already in the economy and benefiting American corporations, in the form of purchasing shares or being available for investment in a banking system or whatnot.

And was that an accurate characterization of your position? Very briefly, please.

Mr. KLEINBARD. Yes, in respect to the cash. In respect to the liquid—

Mr. YOUNG. That is right.

Mr. KLEINBARD [continuing]. Permanently reinvested earnings, yes, sir.

Mr. YOUNG. So then if I could get another perspective, Mr. Oosterhuis, are there not benefits to having more liquidity, not just in terms of sort of abstract economic liberty terms, but are there some economic benefits to having that money repatriated and, thus, allowing those who hold the funds to have greater flexibility to start new businesses, expand existing businesses, spend the money domestically, invest in capital equipment, thus leading to higher personal incomes? Is that something that you can speak to, sir?

Mr. OOSTERHUIS. Well, yeah, I absolutely can speak to it. And I do think it is, as I have said before, quite beneficial for repatriation to be able to take place. I don't want to overstate it. It is true, money is in bank accounts that are largely in U.S. dollar accounts. Of course, our banks are not lending now, we know, so that money is just sitting on deposit with the Federal Reserve, offsetting some of their asset purchases. So it is not clear to me it is really helping the economy in any significant sense today.

But the important thing is that it distorts corporate behavior. I see it all the time. Companies don't like to have excess cash on their balance sheet. They want to put it to productive use. Cash does not generate earnings. Cash generates very, very small earnings for them. What generates earnings for them are real assets.

And so, because the cash is abroad and they don't want to pay the tax to bring it back, they bias their investments towards foreign assets. That is just a reality of the system. It makes perfect sense. If you had to pay a 25 percent tax to buy something in the United States and didn't have to pay the 25 percent tax to buy something in Europe, of course you would buy something in Europe.

Mr. YOUNG. All right. I am going to try and tease this out further. I do want to be fair on this. It is an interesting exchange.

Mr. Kleinbard.

Mr. KLEINBARD. And I agree with what Paul just said.

Mr. YOUNG. Okay. So in terms of growth of our economy, we would see a benefit to further repatriation here. It is not a net-neutral issue. We want to make reforms within the code here that will lead to a greater repatriation because that will grow the economy.



I think that was confusing, in terms of the earlier testimony and some of the statements that were made.

You know, in my remaining time here—I have 30 seconds left—I think I will just yield it back and look forward to speaking with some of you offline. Thanks so much for being here.

Mr. TIBERI. Mr. Davis is recognized for 5 minutes.

Mr. DAVIS. Thank you very much, Mr. Chairman.

And let me thank you gentlemen for the insights that you have conveyed. It has been a very interesting and productive, I think, discussion.

In the last few weeks, we have heard a great deal about Apple and its taxes and not taxes, what it has paid and what it should have paid and should not have paid.

I note in your testimony, Mr. Oosterhuis, you argue, essentially, that a company's profits should be thought to occur where its sales are. Apple's main activity is research and development. The actual manufacture of its product is outsourced, and 95 percent of the research and development takes place in the United States.

Mr. Kleinbard, it seems that the business activity that is generating Apple's profits, even on offshore sales, is largely in the U.S. and that those profits would not be possible if not for the patent protection, educated workforce, infrastructure, and other public investments made possible by U.S. taxpayers. Would you agree?

Mr. KLEINBARD. I would.

And what you are saying, Mr. Davis, is consistent with the point that I have been trying to emphasize, that we should conceptualize all this as a tug of war between the home country on the one hand and the market country on the other. The Apple case is a powerful case for why some tax revenues belong in the home country, not in the destination country.

Mr. DAVIS. Mr. Oosterhuis.

Mr. OOSTERHUIS. Yes. Two points on that.

First of all, Apple is a company that spends about 3 percent of their revenues on R&D. That is relatively low. Apple is a company that has become fabulously successful because they had ideas that captured consumers. And a lot of that has to do with the consumer-facing side of the business, not the R&D side of the business.

They were able to capture products that not only sold at premium prices but that led to annuities of income when people bought movies, they bought books, they buy records. They buy all kinds of things that Apple gets a piece of. That is a terrific business model that they built. That requires real value in the countries where the customers are, because it is the customers that are paying those premium prices.

If Samsung had done what Apple had done and was shipping its smartphones into the United States and charging premium prices, you know that the IRS would be saying the bulk of the value should be in the United States, even if the phones were invented in Korea. And that is the reality of it. There is tension between the two.

My point in saying that the bulk of the profits should be in the market country is that that is the least mobile way to allocate the profits among the countries and the best way to minimize the dis-

tortion of people moving jobs and moving activities around the world for tax purposes.

Mr. DAVIS. Then let me move on a bit, if I might. And let me just—it is hard for me to reconcile the notion—and I certainly hear the argument, but I also note that you argue that the U.S. should not be too concerned if a company like Apple seems to be avoiding taxes that it ought to pay to foreign governments on its foreign profits.

But once we recognize that much of the profits that Apple characterizes as “foreign” are really U.S. profits, because all the research and development that created those products took place in the United States, then I think that avoidance of foreign taxes becomes a problem.

Now, Mr. Kleinbard, you indicated that in your testimony. And I guess my question becomes, do you think the United States has a bit of self-interest in helping to protect the tax base of foreign countries?

Mr. KLEINBARD. I actually do, once we understand that foreign countries means the market countries. What we want to get to is the tug of war. The United States will win its fair share of those tugs of war.

What we don’t want is a case like Apple, where the income is not being taxed either in the market country or in the source country. That is the fundamental problem that the Apple case demonstrates, is that the income has escaped tax everywhere.

Now, I think that income, in this case, is more appropriately taxed in the United States. I don’t think that Apple is in the business, like maybe a Nike, of having different shoe models in every country. They are selling the same iPhones everywhere in the world. It is the same global platform. For that reason, I think the profits are in the U.S.

Other cases, you know, may be different. But we will win our fair share of the tug of war. What we have to get out of is the idea that we will allowing the siphoning off of cash to nowhere.

Mr. DAVIS. Thank you, Mr. Chairman. I yield back.

Mr. TIBERI. The gentleman’s time has expired.

Mr. Renacci is recognized for 5 minutes.

Mr. RENACCI. Thank you, Mr. Chairman.

And I want to thank the witnesses, too. It is interesting, as Mr. Young said, being here at the end and listening to all the conversation. You get to kind of go back and re-discuss some of the issues.

You know, I still question this trapped issue. Mr. Kleinbard, you had indicated—and I know Mr. Young brought this up—that these earnings aren’t trapped. They are coming back; they are in bank accounts.

Mr. Oosterhuis, you were saying—I think you disagree with that, though. I want to just—can you—

Mr. OOSTERHUIS. Actually, I think Ed and I agree that there are much more productive uses of that cash than sitting in bank accounts. And so if companies could bring the money back and have tax-neutral decisions on whether to invest it and where to invest it, that would be an improvement.

Mr. RENACCI. Because it is not being used by the company to put back into the business here in the United States, correct?

Mr. OOSTERHUIS. Or anywhere. Yeah.

Mr. KLEINBARD. Well, right. My point is that the cash, the very large sums, perhaps as much as a trillion dollars, is in the U.S. economy, but it is not optimally allocated.

And where Paul and I agree is that there is an incentive to use that cash to make foreign acquisitions. I think of Microsoft Skype, for example, as a perfect example, when Microsoft bought Skype.

Mr. OOSTERHUIS. HP Autonomy.

Mr. KLEINBARD. Or HP Autonomy. Well, I was trying to think of a more successful example.

Mr. RENACCI. The other thing that I thought was kind of interesting, I know one of my colleagues talked about the deferral is a tax break that causes companies to ship jobs overseas.

I am a CPA; I have had to look at tax consequences of many businesses. My question would be, is this really a tax break, or is this just something that is really part of an outdated Tax Code?

Mr. OOSTERHUIS. I think it is the latter. It grew up from the 1920s practice of taxing companies that were incorporated in the United States and not taxing companies that are not incorporated in the United States, without regard to who owns the shares of those companies. It wasn't intended as a tax break.

Mr. KLEINBARD. I think of it as a thing. And, you know, when I was at JCT, one of the things I tried to do was to change how we scored that as a tax expenditure and say, no, it is not a tax expenditure, it is just a thing, it is just a structural way we have chosen to do our international tax system.

The right question is, what should the international tax system be? Whether you call this a break or you call it an outdated norm is unimportant. It is just a thing. It has economic consequences. We can do better than the current thing.

Mr. RENACCI. Mr. Kleinbard, you said a 25 percent rate across the board is something that you believe in.

Mr. KLEINBARD. And it is right at the OECD norm. The OECD average is about, what, 24? Twenty-four.

Mr. RENACCI. Mr. Oosterhuis, where do you see that?

Mr. OOSTERHUIS. No, I think that is definitely too high.

First of all, as I have said before, the statutory rates aren't the complete answer because of the incentives that are built into the systems in foreign countries to reduce those rates. The U.K. patent box at a 10 percent rate is a classic example. Their corporate rate will be going down to 20 percent, but they will have a 10 percent box. So the effective rate will be substantially lower for high-intangible-value companies.

Second, that doesn't say anything about what Ed calls his stateless income or third-country earnings. There are always going to be some third-country earnings, whether it is in Samsung's system or in Glaxo's system or in Novartis' system. They are going to have that. So their effective tax rates—and those are the companies U.S. companies compete with—their effective rates will be lower than their local statutory rates by that reason, as well.

So if we are taxing U.S. companies at 25 percent, when those companies have—I mean, Lenovo's tax rate is under 20 percent, for example. Why should we give our companies that kind of competitive disadvantage?

If we are going to tax worldwide income, it needs to be at a low enough rate that it basically approximates the amount of foreign tax they will, in fact, pay. And that is between a 10 and 15 percent rate, in my judgment.

Mr. RENACCI. It is interesting, I know my time is running out, but the one thing I think everybody agrees to is we have to simplify this and we have to bring the rate down. And whether it is 25, 10, 15, it has to come down.

So I appreciate your comments. Thank you.

I yield back.

Mr. TIBERI. Ms. Sánchez is recognized for 5 minutes.

Ms. SANCHEZ. Thank you, Mr. Chairman.

And I want to thank our witnesses for being with us today.

Mr. Chairman, as you know, I recently sent both you and the ranking member a letter urging that the bipartisan task force's—that that process continued to the next logical step, which is trying to construct some policy. Because I think we need to and can get concrete bipartisan tax reform proposals on paper. And if we are serious about a bipartisan comprehensive tax reform, I think the task force working groups are a way to keep that process moving.

And if we can do that, I think we can put together a fairer and simpler Tax Code that provides the long-term certainty that businesses crave and makes America more competitive in our global economy.

Our hearing topic today arises from the fact that our current laws make it perfectly legal for huge multinational corporations to avoid paying taxes on mind-boggling sums of money. And while our statutory corporate rate may be the highest of any country in the OECD, the U.S. has the second-lowest corporate taxes as a percentage of GDP of all the OECD countries.

Companies with the resources to transfer profits and jobs abroad have an unfair advantage over truly domestic companies that do their research here, provide good-paying jobs here, and manufacture products in the U.S. And I think that leveling that playing field is long overdue.

Throughout the task force process, our manufacturing group heard over and over again from domestic manufacturers that foreign governments aggressively offer research and development incentives and packages to try to lure them, their company's research and intellectual property overseas. We would love to keep those innovative, high-paying jobs and the IP that goes with them in this country, preferably in southern California.

But I want to take my time to focus on domestic businesses, specifically manufacturers, who, as Mr. Kleinbard noted before the Senate Finance Committee in 2011, are the truly disadvantaged actors in our current system because they can't engage in those base-erosion activities that multinational corporations can.

So my question is directed to Mr. Kleinbard.

If we can close offshore loopholes and get this money back into our economy, what kinds of changes could we make to incentivize domestic manufacturing growth for companies that invest in high-tech R&D and manufacturing here in the U.S.?

Mr. KLEINBARD. Two quick thoughts.

Whatever system you go to, if it is well-designed, U.S. multinationals are going to pay more tax, and the only question is, will they pay it to the United States or will they pay it to foreign countries? So their tax burdens will go up. What choice can there be, when their tax burdens on their foreign income today are measured in single digits?

The question of domestic manufacturing is a very difficult one because, frankly, I am skeptical of the utility of tax expenditures in the form of R&D credits and the like. They are very expensive subsidies, and they are often poorly targeted subsidies because they go to firms that would behave in exactly the same way without the subsidy. So that is just money wasted by government.

I would use all the revenue you can raise to lower the rate to whatever it is. Twenty-five is my opening bid. If you guys can come in at 22, more power to you. Whatever it is, that is the way to go. The subsidies are just extremely expensive, because they go to people who don't need them in the end.

Ms. SANCHEZ. A follow-up question on that: Do you prefer things like Section 199, which actually ties incentives to wages for workers?

Mr. KLEINBARD. You know, I am not a fan of any of these programs, honestly. 199, as you all lived it, became a broader and broader concept as to what was included. Movies suddenly came in. Pouring coffee suddenly came in. The subsidy grew and grew and grew by virtue of the nature of the political process.

I think it is the wrong direction. You know, the right direction—and, you know, Mr. Ryan said this yesterday. We are drowning in tax expenditures. Let's not figure out which subsidies we should add. 199 distorts decisions as to what is covered, what is not covered, you know, wages as opposed to investment in capital equipment that might lead to higher incomes in the future.

The tax system ought not to be in the business of trying to steer the economy. We ought to do what we can to have a low, consistent business rate and declare a victory and let business take care of business,

Ms. SANCHEZ. Thank you.

I yield back.

Chairman CAMP [presiding]. Thank you.

I will go to Mr. Pascrell now.

Mr. PASCRELL. Thank you, Mr. Chairman.

The issue of the big, multinational corporations like Apple reducing the tax bill into the teens by shifting their profits to offshore havens has been in the news lately. And we are all concerned, as we should be. I believe that this is an "alert" sign, that issue, to all of our attempts to reform the Tax Code. I believe it is very significant, more so than we think.

We are coming out of one of the worst economic crises in our Nation's history. Many Americans are playing by the rules, most Americans, and are still struggling to get by. That is not a question. That is data.

When you see what happened after the Second World War up to 1973, in terms of productivity and return, when we still believed in sharing of wealth. And then what has happened from 1973–1974 to 2011 and 2012, where we stopped sharing the wealth? Produc-

tivity increased, and folks were participating less in the sharing of it.

So we have gone from a stakeholder society to a shareholder society. There are no two ways about it. That is the data. That is what it shows.

And then we look over at corporate America, and we see these big companies, these big conglomerates, as we call them—whatever name we choose. And they are worthwhile in this society; that is not the question. Big accounting departments changing, bending, exploiting the Tax Code—average person doesn't have all of these folks at his fingertips to do these things—to make sure they are contributing as little as possible.

We are talking here, time after time, Mr. Chairman, we talk here about how we are going to help corporate America. We have very few meetings about how our Tax Code can help the poor, unless I missed any meetings I didn't know about.

Chairman CAMP. Well, we did have a working group on exactly that subject, including 10 others.

Mr. PASCHELL. I think it is un-American, Mr. Chairman, if I can use those terms. I think that is a good word to describe it. So we need to fix it.

So let me ask you, Mr. Kleinbard, this question. Corporate taxes once made up about a quarter of Federal revenues, many moons ago. In fact, to the 1950s that was the case. Now it is down to below 10 percent today. That didn't just happen. I mean, somebody didn't just wake up some morning and say, we had better start changing this and moving things around. This government, our Government of the United States, a representative government, changed the rules.

Many corporations are now calling for further reductions in the corporate tax and a shift to a so-called territorial system in order to keep this competitive.

Do you believe—you, personally—that this is possible to do in a revenue-neutral way? Will a shift to such a system lead to an increase or a reduction in the amount of corporate tax collected?

And if corporate tax collections go down, what are the Federal Government's other sources of revenue that will go up to compensate? Who pays for them?

Mr. KLEINBARD. This is a very important question.

And for the historical pattern, we have to keep in mind that the United States embarked on a unique path of disincorporating business. So, today, more than half of business income is simply not in corporate form, but it is still in the U.S. tax system. It is taxed through the individual system, because we have gone on this unique path to disincorporate business in America. So that explains some of the data.

My belief is—well, the JCT estimates will be what they are. And I think the tax rate has to be driven by that. There is a great deal by way of business tax expenditures that make no sense to me. You know, this is not the Soviet Union, we don't engage in Soviet 5-year plans for the economy. So we should get the United States of America, the government, out of the business of subsidizing individual companies or industries. That brings a lot of revenue onto the table to buy down the rate.

And, again, although it may not be generally appreciated, if you do a sensible job in this committee, whatever you end up doing, multinationals are going to pay more tax. The only question is, how much of that does the U.S. grab as opposed to foreign market countries? And, you know, that will be a very interesting question, very interesting to see how JCT scores it.

Finally, you have the \$2 trillion pot of old earnings. And I keep emphasizing, this is the only time that this committee will ever be confronted with the opportunity to have an efficient tax. You can tax those old earnings in the transition to the new system. They rate higher than 5 percent and are sufficient to help fund the revenue costs of moving to the new system.

Under no circumstances do I contemplate moving to a corporate system that is a net revenue loser.

Chairman CAMP. All right, thank you.

Mr. PASCARELL. Thank you.

Thank you, Mr. Chairman.

Chairman CAMP. And for our final Member to question this morning, Mr. Kelly.

Mr. KELLY. Thank you, Mr. Chairman.

And thank you all for staying so long.

I am interested in a couple different things. We certainly have a lot we can talk about.

But there is an old saying I remember that goes something like, build a better mousetrap, and the world will beat a path to your door. That is accredited to Waldo Ralph Emerson. But what he really said, if a man has good corn or wood or boards or pigs to sell or can make a better chair or knife, crucibles or church organs than anybody else, you will find a broad, hard-beaten road to his house, though it be in the woods.

Now, we are talking about tax strategies here. Now, you all understand it because you do it every day, but for the average American, the average American, who relies on us to do the right thing for them and talk to people like you to come to an answer to this, a code that is 75,000 pages, that American companies and individuals preparing their taxes spend \$168 billion—that is with a “B”—to do the preparation, and almost 7 billion hours, gosh, do you think that is a little difficult?

So my question to you, as we talk about all this—it doesn’t matter to me how we get there, but if our goal, our stated goal, is pro-growth tax reform—because what we are talking about, we need the extra revenues. Where would you get them? Who pays taxes?

Mr. OOSTERHUIS. People.

Mr. KELLY. People.

Mr. OOSTERHUIS. People pay taxes.

Mr. KELLY. People who work. What kind of companies pay taxes? Only profitable companies.

So if we create a Tax Code that is so complicated that drives them offshore and then say, these are bad folks, they are not patriots, they are willing to take their business offshore—it is not that they are unpatriotic, it is just that they are not stupid.

We have created a system—and I have a lot of people I represent back home that are in the host business; it means they have bars.

You can keep customers out of your bar by raising the cover charge. And I am suggesting that is what we have done.

Now, if we are looking for revenue and if we are looking for success and we are looking for profits, then wouldn't the idea be a government that is actually an advocate for your success and not an adversary? Would that be a little better model?

Now, we talk about international Tax Code. Why would we want to do this? This strategy is a huge part of every business's and every individual's life. My gosh, you have to look at it. And you have to hire somebody else do it because it is too complicated. And the real fear is not that you are going to pay too much; it is that you are going to make a mistake, and somehow you are going to come under greater scrutiny.

Anyplace else in the world that makes it tougher than in the United States? You know the international boundaries.

Mr. KLEINBARD. I have never done research on the individual compliance—

Mr. KELLY. No, but you talk to companies all the time. Tell me why companies—tell me why we are no longer one of the best places to start a business.

Mr. KLEINBARD. Well, first of all, you know, I am now an academic—

Mr. KELLY. Not to be disrespectful, the reason is it is too hard.

Mr. KLEINBARD. Well, I don't agree with the premise of the question, that we are not one of the great places.

Mr. KELLY. Well, I am only going by the rankings. We are way down.

Mr. KLEINBARD. Well, the rankings—you know, there are a lot of interesting opinion polls. I don't think—

Mr. KELLY. No, no, I am not talking about opinion polls. I am talking about hard facts. I am talking about batting averages. I am talking about completion yards after the catch. This is a tough place to start a business in.

Mr. KLEINBARD. It is legendarily—

Mr. KELLY. And the government is too—

Mr. KLEINBARD. That is simply false.

Mr. KELLY. It is not false.

Mr. KLEINBARD. It is simply false. This is the easiest country in the world in which to get—

Mr. KELLY. Then why are they not flocking here? Why are they going to Ireland? Why are they doing other things?

Mr. KLEINBARD. Because no country can compete with zero. That is simply the problem.

Mr. KELLY. I get it. I get it.

Mr. KLEINBARD. The problem is that we have allowed a system in which companies are able to reduce their tax rates to zero or to single digits. That is not a rate that any actual economy operates under—not the U.K., not Germany, not France, not the United States.

Mr. KELLY. I get you. I get you. But it still comes down to, does it not, it comes down to usually people do business where it is easiest to do business.

Mr. KLEINBARD. Again, it is easy to start a business in this country. You don't have—



Mr. KELLY. Mr. Kleinbard, have you ever started a business?

Mr. KLEINBARD. My wife did.

Mr. KELLY. Sir, just a yes or no.

Mr. KLEINBARD. I was a partner in a large——

Mr. KELLY. Okay.

Mr. KLEINBARD [continuing]. Business.

Mr. KELLY. All right. Well, me, too.

Mr. KLEINBARD. My wife started a business.

Mr. KELLY. I do own a business. I am going to tell you right now, it has become so difficult, so heavily taxed, and so heavily regulated, we are not the premier place to start. People are going elsewhere. Why?

This is this greatest market in the world. It is a global economy, Mr. Buchanan said. Shouldn't we be looking at establishing a Tax Code that is a pro-growth Tax Code that allows people to look at us and not just participate in the global economy but dominate the global economy?

My goodness, with all the natural resources we have, with all the advantages we have, I would hate to be sitting there with a tin cup looking for other people to help us. We don't need to. We have been endowed by God with the greatest assets in the world at any time in the history of the human race, and we can't get out of our own way. We have gamed ourselves.

So I appreciate you being here.

Mr. Oosterhuis, I would have liked to get to you because I really admire what you said and understand it.

And, Mr. Saint-Amans, thank you for being here.

Mr. Chairman, I yield back.

Chairman CAMP. Well, thank you.

And I want to thank our witnesses. This is a very important hearing, and I very much appreciate the quality of your testimony this morning. And I want to thank you for the contributions you have made to this issue.

And, with that, this hearing is adjourned.

[Whereupon, at 12:40 p.m., the committee was adjourned.]

