MEMORANDUM

FROM: Michael Best Strategies

DATE: October 3, 2017

SUBJECT: Senate Finance Committee – International Tax Reform

Overview:

On October 3, the Senate Finance Committee held a hearing on "International Tax Reform." Topics discussed in the hearing included: Base Erosion/Territorial Tax System; Revenue Neutrality; Corporate Tax Rate; Consumption Tax; Legislative Process for Tax Reform; Earned Income Tax Credit/Trade Adjustment Assistance; Passthroughs; International Trends; Prescription Drugs; Tax Loopholes; Apprenticeship Training; and Intellectual Property.

Witnesses:

Mr. Bret Wells, Professor of Law, University of Houston
Dr. Kimberly Clausing, Ph.D., Thormund A. Miller and Walter Mintz Professor of Economics, Reed College
Mr. Stephen E. Shay, Senior Lecturer on Law, Harvard Law School
Mr. Itai Grinberg, Professor of Law, Georgetown University Law Center

Opening Statements:

Chairman Hatch (R-UT): This hearing will focus on another piece of the "tax reform" puzzle. Chairman Hatch explained last week he joined with others to put forward a broad unified framework for tax reform. He stated this is only one step in tax reform but he suggested it is a big step. Groups are already attempting to reverse engineer a completed plan from the framework. The framework does not contain information on issues such as breakpoints for the individual tax brackets, the value and indexing of the enhanced Child Tax Credit, or the precise rate for the top bracket. He explained without this information it is impossible to conduct a credible analysis of the framework. Chairman Hatch stated the Committee will be responsible for writing the Senate tax reform bill and he stated outside analysis should be taken with a "grain of salt." He expressed his desire for this to be a bipartisan effort. He suggested this hearing is an area where there is large agreement. He noted the ability to defer foreign earnings until they are brought back into the U.S. Subpart F [the U.S. passive international income regime] can be fairly confusing and American companies have been using a number of schemes to continue to hold earnings offshore because of the worldwide tax system. He stated there is $2.6 trillion in income being held offshore. Chairman Hatch believes a change to a territorial system is needed so that income earned in other jurisdictions would only be taxable there. He stated anti-base erosion rules would have to be included in this framework as well. He expressed his interest in the idea of better integrating the individual and corporate tax system. He expressed his belief that corporate integration, by means of a dividends paid deduction, can significantly help with some of the existing problems.

Ranking Member Wyden (D-OR): Ranking Member Wyden stated there is an opportunity to find common ground on tax reform. Some of the principles the Democrats have discussed in their letter are an opportunity for common ground. But the framework is a "con job" as employees do not benefit from corporate rate cuts. Wyden noted that the Administration removed the studies showing those facts while leaving up others that support their views. Ranking Member Wyden stated the framework is supposed to curb the inversion "scourge." He explained the American people want good jobs with good wages and corporations should pay their fair share. He suggested the framework is essentially a corporate wish list, a massive tax cut, base erosion, and an invitation for corporation to "game the system." Ranking Member Wyden stated the framework is a "green light" for multinationals to not pay taxes. He stated the tax base will continue to erode and individual taxes will therefore have to "skyrocket." He noted this is not the first attempt to reduce the corporate rate. He explained every percentage point decrease in the corporate tax rate results in a loss of $100 billion in revenue. Ranking Member Wyden stated the framework does not resemble what Ronald Reagan accomplished. He stated international taxation will be a key part of the debate and involves very complicated questions.

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Witness Testimonies:

Mr. Bret Wells: He stated a partial dividends paid deduction regime in part with a capital gains/dividends preference can result in a reduction in disparity between passthrough and C Corps. Wells stated from the perspective of the foreign based entity, outside its place of residency only the business profits attributable to a certain territory are subject to taxation in the various inbound host countries. He explained the foreign based entity is provided a territorial result regardless of the formal tax choices made by a particular host country. Wells suggested that, faced with this reality, each host country must decide whether or not to have a system of international taxation that would disadvantage their own resident corporations or would instead afford comparable taxation to resident enterprises as are afforded to inbound foreign based entities. He stated every other G-7 country has opted for some form of a territorial tax regime. He suggested Congress should adopt a territorial regime but needs to also protect against profit shifting activities. Wells noted that inbound companies [foreign-based multinationals] can "strip" income from the United States in several ways, listing five including: 1) related-party interest 2) related-party royalties 3) related party leases, 4) supply chain and 5) related party service transactions. Wells stated a source taxing solution would implement base protection measures which apply to both resident and foreign enterprises. He stated source taxation would be preferable approach as compared to Subpart F. He stated leveling the playing field requires Congress to address inbound earning stripping techniques. He suggested corporate inversions are a symptom of the larger earnings stripping "cancer." Wells suggested that corporate inversions are the "alter ego" of inbound earnings stripping and should not be considered a separate problem. He stated Congress needs a new approach to the earning stripping problem. He suggested that adopting a base protection surtax would accomplish this new approach.

Dr. Kimberly Clausing: She said that there is a tradeoff in international taxation between tax competitiveness and base erosion. She said the most mobile multinational companies do not have a competitiveness problem, suggesting that U.S. companies dominate lists of the world's top companies. She noted that U.S. corporate tax revenues are one third lower than those in peer countries relative to the size of the economy. She stressed the need for additional investments in infrastructure, education and research. Clausing said international profit shifting costs the U.S. $100 billion every year. She said the proposed new rates on passthrough income will create a huge new base erosion problem. She stated that moving to a territorial system will make the base erosion problem worse, stressing the need for tough base erosion protection mechanisms. She recommended implementing a per country minimum tax, suggesting that it would be more effective than a global minimum tax, if a territorial system is enacted. Clausing stated that a more coherent strategy would be to combine a corporate rate reduction with the elimination of deferral of foreign earnings [in a worldwide tax system]. She said this would eliminate the appeal of tax havens. She recommended combining this approach with measures to prevent inversions. Clausing said it does not make economic sense to give tax breaks on repatriated "haven earnings." She said business tax cuts primarily benefit those at the top of the earnings curve. She noted that analysis by the Tax Policy Center showed that the Big-6 proposal would give 80 percent of the benefits to top earners. She emphasized that tax reform should not increase the deficit. Finally, she expressed support for implementing a carbon tax.

Mr. Stephen E. Shay: Believes tax reform should be revenue neutral or increase revenues, expressing opposition to proposals which would increase the deficit. He stated that tax reform should maintain or enhance the current tax code's level of progressivity. He said a reduced holiday tax rate on U.S. multinationals pre-effective date offshore earnings would overwhelmingly benefit high income Americans and foreigners. Shay said his first choice would be to follow the Wyden/Coats approach to international tax reform [i.e., eliminating deferral in a worldwide system]. He contended that evidence does not show that U.S. multinationals are overtaxed or uncompetitive. He said foreign subsidiaries of U.S. multinationals paid an average foreign tax rate of 12 percent. Shay noted that a territorial tax system was proposed in the GOP framework tax plan. He suggested that if not implemented properly this proposal could make the situation worse, emphasizing the need for a minimum tax. He said the minimum tax should be a relatively high percentage of the U.S. tax rate, contending that it should be 60-80 percent of the U.S. rate. He asserted that the minimum tax rate should be applied on a country-by-country basis, rather than on a global basis. He expressed support for implementing a foreign tax credit in any minimum tax regime, but stressed that it should be pro-rated so that the amount of foreign taxes credited should not be greater than the portion of those taxes that the minimum tax rate bears to your regular tax rate. He stated that he supports the goal of strengthening source taxation rules, though he has concerns with Wells' specific proposal to do so.

Mr. Itai Grinberg: There is widespread consensus that the U.S. needs to move away from its worldwide tax system, lower the rate, and move to a territorial tax system. He said the U.S. has the highest statutory corporate tax rate in the OECD and its effective tax rate is also very high. He noted that the U.S. is the only major developed economy which has not implemented a territorial system. Grinberg said lowering the rate and moving to a territorial system are "not enough," stating that the U.S. tax system creates relative tax disadvantages for being a U.S. multinational. He said the U.S. system makes foreign ownership more attractive than U.S. ownership, which creates incentives for inversions and income shifting. He said the reliance on Subpart F as the main anti-erosion device is the source of the problem. He noted that last year 97 percent of inbound foreign direct investment was an acquisition rather than a new investment. He stated that acquisitions of existing U.S. businesses do not necessarily create jobs and can actually cost U.S. jobs. Grinberg stressed the need to both lower the tax and level the playing field. He said the foreign tax credit in the current system encourages "revenue grabs." He stated that countries around the world are shifting to greater source-based taxation, and that clinging to current law will make U.S. companies less competitive and cause additional revenue grabs. Grinberg said there is no international status quo on source taxation, suggesting that the U.S. will have to respond over time to the policies of other countries. He stressed the need to put the U.S. in a position of strength in multinational negotiations on source taxation. He suggested implementing an inbound corporate minimum tax which applies to all foreign multinationals, suggesting that it would provide base protection without the negative consequences of a Subpart F minimum tax.

Questioning:

Chairman Hatch (R-UT): He asked if foreign multinationals have significant tax planning opportunities, such as earnings stripping, that U.S. multinationals do not have. Wells responded in the affirmative. He said the main U.S. base protection measure, Subpart F, only applies to resident companies. He stated that corporate inversions are the result of U.S. companies wanting to be treated like foreign multinationals. He stated that internationally the U.S. is competitive in international markets, but in the U.S. the tax rate applied to U.S. companies is significantly higher than that applied to foreign companies. He said foreign companies should not be treated in a discriminatory way, but they should not be given an advantage over U.S. companies. Clausing said the playing field should be leveled for U.S. and foreign companies. She said it is easier for foreign companies to strip earnings, suggesting that earnings stripping regulations could be tightened. Shay said steps are needed to improve source taxation, but stressed that there are structural advantages in every tax system in the world for companies which are not resident to invest locally. He emphasized that this is not a U.S.-only problem. He stated that whatever the U.S. does will be copied internationally, stating that the action taken should not be discriminatory. Grinberg said U.S. multinationals are impeded by Subpart F in ways that foreign multinationals are not. He said this advantage makes foreign acquisitions of U.S. firms more common than U.S. acquisitions of foreign firms. He stated that moving to a territorial system would make the U.S. more likely to be the acquirer.

Senator Isakson (R-GA): He asked how Clausing would install "teeth" in a territorial tax system. Clausing said she would install a per-country minimum tax. She stated that she would implement tougher earnings stripping regulations and provisions to prevent inversions, such as an exit tax and an increased threshold that's required to invert. Wells said business taxes in the U.S. should be the same for both U.S. and foreign companies. He said inbound investors should not face a double tax, but should be on a level playing field with U.S. companies. He suggested that leveling the playing field would prevent inversions. He stated that a territorial regime must address the round tripping problem. He stated that round tripping is what multinational foreign based companies can do today. Senator Isakson said Georgia has benefitted from foreign direct investment. He asked if imposing different rates on different countries could impede this investment. Clausing clarified that she was not proposing different rates for inbound investment from different countries. Isakson suggested that moving to a territorial system would end the repatriation issue. Wells said he agrees, depending on what is done regarding the earnings currently held abroad.

Senator Toomey (R-PA): He said the U.S. tax system is uncompetitive internationally, due to the high rate and the global tax system. He stated that foreign direct investment can be constructive if done for economic reasons. He asked how the current system is harmful to American workers. Grinberg said it is harmful in a plethora of ways. He stated that in many foreign markets U.S. companies are disadvantaged relative to foreign companies because they face a worldwide system with deferral, while other companies face a territorial system. He stated that U.S. companies are disadvantaged in the U.S. Senator Toomey said the U.S. tax code creates incentives to headquarter multinationals outside the U.S., suggesting that headquarters are often sources of good jobs.

Senator Thune (R-SD): He asked what form that leverage should take. Grinberg stated foreign direct investment supports increases in jobs and is important. He suggested the U.S. should level the playing field. He noted foreign countries are taking steps to "go after" U.S. companies. He suggested a principled approach in which there is an inbound minimum tax that treats U.S. and foreign nationals the same. He asked whether tax reform contributes to economic growth. Wells stated it will contribute to greater growth. He stated base protection measures that level the playing field will provide revenue for Congress to meet other needs. He explained other countries have "self-helped" themselves to a territorial regime. He stated there need to be rules that apply to U.S. and foreign countries to raise the revenue needed and ensure winners and losers are not created. He explained Subpart F only applies to U.S. companies.

Senator Cassidy (R-LA): Senator Cassidy stated Shay claimed that a country-by-country minimum tax is needed. He asked Grinberg whether this is needed in his view. Grinberg suggested an inbound minimum tax would be most appropriate, not an outbound minimum tax. He stated if there were an outbound minimum tax then a country-by-country approach is not how the world works. He stated country-by-country in that context is unworkable. Wells agreed it would be impossible to implement.

Senator Wyden (D-OR): Senator Wyden asked if "tax cuts pay for themselves." Clausing and Shay responded in the negative. Wells said other things must be in the system to offset the revenue. He stated that the tax cuts alone will not pay for themselves. Grinberg said appropriate tax reform can increase economic growth, but only by a certain amount. He stated that tax cuts do not pay for themselves. Wyden expressed opposition to eliminating the requirement that the bill be scored. He also noted the Trump tax framework states that a corporate tax rate cut will primarily benefit U.S. workers. He stated that the mainstream consensus of economists is that the benefits of a corporate rate cut would go overwhelmingly to shareholders. He suggested that at most 20-25 percent of the benefit would go to workers. He asked if this is accurate. Clausing said all of the mainstream models, including the Joint Committee on Taxation (JCT), the Congressional Budget Office (CBO), the Tax Policy Center, and the Treasury, give about 80 percent of the benefit to capital or shareholders. She said corporate rate cuts primarily benefit managers and shareholders.

Senator McCaskill (D-MO): She asked if anything in the Republican tax proposal would address the wide disparity in taxes paid amongst U.S. companies. Clausing said there is nothing in the plan to level the playing field amongst corporations, though it would lower the top rate. Grinberg said the 22 percent rate figure is based on a very specific calculation. He noted that the Treasury under the Obama Administration said that version of calculation is backwards-looking and not necessarily helpful in assessing future investments. He asserted that U.S. companies are uncompetitive internationally. He contended that factors resulting in different industries paying different rates should be cleaned out of the code. Shay said the Republican proposal would worsen this problem. He noted that that the proposal would apply expensing to all assets. He recommended moving to economic depreciation for all assets..

Senator Cardin (D-MD): He asked if the U.S. can be competitive with a 35 percent corporate rate. Wells said the unlevel playing field needs to be fixed. Grinberg said he supports using a value added tax (VAT) to lower corporate and individual rates, but stressed that this proposal should not impede action on tax reform. Cardin said he is prepared to move on tax reform, but not by increasing the deficit and jeopardizing entitlement programs.

Senator Bennet (D-CO): He asked if Congress can reform the tax code without creating unintended consequences in only 23 days. Wells said it is difficult to say without seeing legislative language. Clausing said it would be very difficult. She suggested rushing could result in the loss of revenue if base erosion provisions are not properly structured. Shay agreed with Clausing. He stated that major changes should not be made in such a short period of time. Grinberg suggested that tax reform debate has been ongoing for 6 years. He stated that it will depend on the legislative language. Senator Bennet asked if in adequately considered legislation could result in loopholes which could be exploited. Wells said it is unlikely that there would be more loopholes than there are now. He stressed the need to address inbound taxation. He said there is very little in the way of inbound base protection measures today. He emphasized the need for a more balanced system. Clausing said the U.S. has a large problem, but suggested that it could be even worse. She said multinational profit shifting is currently costing the U.S. $100 billion per year. She suggested that those losses could increase if the U.S. shifts to a “toothless” territorial system. Shay stressed the need for strong anti-base erosion measures. Grinberg said an inbound corporate minimum tax is not “toothless.”