

**HOW OTHER COUNTRIES HAVE USED TAX
REFORM TO HELP THEIR COMPANIES COMPETE
IN THE GLOBAL MARKET AND CREATE JOBS**

HEARING
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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MAY 24, 2011
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CONTENTS

	Page
Advisory of May 24, 2011, announcing the hearing	2
WITNESSES	
Gary M. Thomas, Partner, White & Case, Testimony	7
Frank Schoon, Partner, Dutch Desk, International Tax Services, Ernst & Young, Testimony	13
Steve Edge, Partner, Slaughter and May, Testimony	23
Jörg Menger, Partner, German Desk, International Tax Services, Ernst & Young, Testimony	37
Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School, Testimony	43
SUBMISSIONS FOR THE RECORD	
Asian American Hotel Owners Association, Statement	103
The Center for Fiscal Equity, Statement	104
The Chamber of Commerce, Statement	111
The Securities Industry and Financial Markets Association, Statement	118
The Working Group on Intangibles, Statement	127
QUESTIONS FOR THE RECORD	
Gary M. Thomas—1	83
Gary M. Thomas—2	86
Frank Schoon	91
Steve Edge—1	95
Steve Edge—2	96
Jörg Menger	99

**HOW OTHER COUNTRIES HAVE USED
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TUESDAY, MAY 24, 2011

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

The committee met, pursuant to call, at 2:00 p.m., in Room 1100,
Longworth House Office Building, the Honorable Dave Camp
[chairman of the committee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Camp Announces Hearing on How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market and Create Jobs

Tuesday, May 17, 2011

Congressman Dave Camp (R-MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on how other countries have reformed their international tax rules to enable companies headquartered in those nations to compete more effectively in the global marketplace. As part of the Committee's ongoing consideration of how best to reform the Tax Code in order to help grow the U.S. economy and create good jobs for hard-working Americans, this hearing will examine the experiences of other countries in order to identify best practices in designing stable, pro-growth tax policies that would help American companies compete against their foreign counterparts. **The hearing will take place on Tuesday, May 24, 2011, in Room 1100 of the Longworth House Office Building, beginning at 2:00 P.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:

At the Committee's May 12, 2011 hearing on international tax reform, the four Chief Financial Officers (CFOs) who testified recommended that in reforming our current international tax rules, Congress should benchmark against the rules that have been put in place by our major trading partners. The CFOs cited several nations as having international tax systems that make those countries' companies and workers more competitive in the global economy. Many countries have had their rules in place for decades, while others have recently enacted major reforms with global competitiveness in mind. Surveying the tax laws in some of those countries will provide the Committee with useful information as it continues to explore options for tax reform.

In announcing this hearing, Chairman Camp said, "Many of our major trading partners have already reformed their tax laws in ways they believe help their companies expand their global operations and in turn support good-paying jobs within their own borders. To make American employers and workers more competitive in the global market, we would be wise to examine those reforms and consider if such rules would be appropriate for the United States."

FOCUS OF THE HEARING:

The hearing will examine international tax rules in various countries with an eye toward identifying best practices that might be applied to international tax reform in the United States. The hearing will explore policy choices that maximize competitiveness and job creation while also appropriately protecting the U.S. tax base.

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 hear-

ing 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 Tuesday, June 7, 2011**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

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

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

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

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

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

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

Chairman CAMP. Good afternoon. The hearing on “How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market” will come to order. Good afternoon. I want to thank everyone for joining us today for the next in our series of hearings on comprehensive tax reform.

Today’s hearing will examine international tax rules in various countries and identify best practices that might be applied here in the United States. The hearing will explore policy choices that must be considered to create a structure that maximizes competitiveness and job creation while also appropriately protecting the U.S. tax base.

This is the second hearing the committee has convened on international tax. During the first hearing, we looked at how America’s high statutory corporate tax rate, the ever-increasing complexity of the Tax Code, and our worldwide system of taxation impairs our competitiveness in the global economy. And during that hearing, a number of witnesses encouraged the committee to benchmark our efforts on international tax reform against what other countries, es-

pecially our major trading partners, have done recently in this area.

Many of our major trading partners across the globe have already reformed their tax laws in ways they believe help their companies expand their own global operations and support good-paying jobs within their own borders. Some of these countries have improved upon the rules they have had in place for decades, while others have recently enacted major reforms with global competitiveness in mind.

Through the testimony of the panel assembled here today, we will discuss the approaches developed and implemented by our global competitors. We hope to learn what influences led other countries to move toward a territorial system and other related corporate tax reforms, such as a lower corporate rate. We also expect to hear some details about the process these countries undertook in developing their reforms, as well as lessons learned and other outstanding issues these countries are encountering with their international tax systems. Finally, in hopes of crafting a system that is uniquely American, we will begin to focus on what a more territorial U.S. tax system would look like, including key design options to consider for the United States.

There is no doubt that the global marketplace is changing. Today it doesn't even slightly resemble the marketplace that America once dominated. As the world economy changes, America must also change and adapt. That begins with transforming our Tax Code so that America can be a more vibrant competitor abroad and a more attractive place to invest and create the jobs we need here at home.

As this committee re-examines the Tax Code and pursues comprehensive tax reform, we are grateful for the insight provided by our witnesses. Thank you all for being here.

I will now yield to Ranking Member Levin for his opening statement.

Mr. LEVIN. Thank you, Mr. Chairman.

And welcome to all of you.

In this committee's last hearing on tax reform 2 weeks ago, we heard testimony from U.S.-based multinational corporations regarding what they believe corporate tax reform should look like. Their testimony illustrated the importance, the complexity, and the controversial nature of these issues.

The corporations indicated that they would prefer sharply lower rates and a territorial system. At the same time, they rejected a notion of a one-time repatriation holiday, acknowledged the need for reform to be at least revenue-neutral, and suggested that the U.S. consider a value-added tax to make up the revenue that would be lost by cutting corporate taxes.

The testimony from the last hearing bears on today's hearing because U.S. multinational corporations, by and large, often describe their desire for a European-style territorial system or a tax system that is similar to that of our major trading partners. Today, I hope we will continue to explore exactly what such statements mean.

If we are going to compare our tax system to our trading partners, it is appropriate to consider the broader context of their corporate tax systems. To say simply that we want to adopt certain territorial features and low statutory rates offered by other coun-

tries' tax systems is somewhat like going out to shop for a car and saying, I would like to have a Corvette engine without worrying about anything else. That engine comes with a number of tradeoffs. When you get that engine, you know not to expect wonderful gas mileage, four doors, room for children, or low-cost insurance. You know that having that powerful V8 will mean compromising on some other things. These compromises and tradeoffs may not be appropriate for everyone.

As we consider the corporate tax systems of other countries, it is important that we pay close attention to the compromises and the tradeoffs that they might entail. What kinds of anti-abuse rules did countries with territorial systems have to adopt to stem erosion of their corporate tax base? What do choices about a corporate tax system mean for other countries' individual tax systems and the necessity of finding other revenue sources, such as value-added tax? What is the broader economic context in which these choices were made? How much do these other countries invest in economic fundamentals, such as education and infrastructure? How does their revenue collection relate to these important investments?

Last, but perhaps most importantly, we should consider the basic differences between our economy and the economies of our trading partners. Our European trading partners, for instance, operate under EU rules that constrain their options for corporate taxation. It is also the case that the U.S. remains the largest economy in the world and we remain the world leader in innovation. How much do we need to follow in the international tax arena? How much do we need to lead?

With these questions in mind, my Democratic colleagues and I look forward to hearing the witnesses' testimony today.

Thank you.

Chairman CAMP. Thank you very much, Mr. Levin.

We are pleased to welcome our panel of experts, all of whom either have extensive experience as law or accounting practitioners in countries that have moved to more territorial-based tax systems or have spent time studying such systems in the halls of academia.

First, I would like to welcome and introduce Gary M. Thomas, a partner at White & Case in Tokyo, Japan. Mr. Thomas has worked in Japan for over 25 years and is a licensed Japanese tax attorney fully qualified to practice before the Japanese National Tax Agency and the National Tax Tribunal. It is my understanding that he is the only U.S. attorney with such qualifications.

We know that it has been an extraordinarily challenging time for Japan and all its residents over these past several months, so we are especially grateful for your willingness to appear before us today.

Second, we will hear from Frank Schoon, a partner at Ernst & Young and originally from the Netherlands. Mr. Schoon heads Ernst & Young's Dutch Desk as part of the firm's international tax services practice in Chicago and has spent more than 22 years of experience in serving multinational clients.

And, third, we welcome Steve Edge, a partner at Slaughter and May in London. A large part of Mr. Edge's practice involves advising multinational corporations on cross-border transactions, and we

look forward to him sharing his expertise about the U.K. tax system.

And, fourth, we will hear from Jörg Menger, a partner at Ernst & Young and the head of the German Tax Desk of the firm's international tax services practice in New York. Before joining the international tax services practice, Mr. Menger worked in the national Ernst & Young office in Germany.

And, finally, we will hear from Reuven Avi-Yonah, the Irwin I. Cohn Professor of Law at the University of Michigan Law School in Ann Arbor. Professor Avi-Yonah is a familiar face here at the Ways and Means Committee, having testified before us several times, and we welcome you back this afternoon.

Thank you all again for your time today.

The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks.

And, Mr. Thomas, we will begin with you. Votes have been called on the floor. There will be two votes. I was hopeful we could get through two of your 5-minute oral testimonies before we broke for the vote. So, Mr. Thomas, you have 5 minutes.

STATEMENT OF GARY M. THOMAS, PARTNER, WHITE & CASE

Mr. THOMAS. Thank you, Chairman Camp, Ranking Member Levin, and Members of the Committee. My name is Gary Thomas. As indicated, I am with White & Case in Tokyo. I appear before you today on my own behalf and not on behalf of my firm or any firm client.

It is a privilege to have been invited here today to testify on how Japan has used international tax reform to assist its companies to compete in the global market, to revitalize Japan's economy by encouraging the repatriation of foreign profits to Japan, and to enhance employment opportunities in Japan.

Prior to 2009, Japan's international tax system bore a remarkable resemblance to that of the United States. Japan imposed its corporate taxes on a global basis, including taxing dividends from foreign subsidiaries, while avoiding double tax by means of a foreign tax credit. Japan's deferred taxation of profits of foreign subsidiaries until repatriation but restricted deferral for profits of CFCs operating in low-tax countries unless an active business exception applied.

The similarity with the U.S. international tax regime was not surprising because, for the past 50 years, the U.S. tax system has been Japan's model. However, on April 1, 2009, Japan moved to a territorial tax regime by adopting a foreign dividend exemption system, pursuant to which 95 percent of the dividends from qualified foreign subsidiaries are exempted from Japanese national and local corporate income taxes. At the same time, Japan abolished its indirect foreign tax credit system.

Why did this substantial change occur? There were a number of key reasons.

First, the Japanese Government concluded that it was vital to encourage the repatriation of profits of foreign subsidiaries in order to assist in revitalizing Japan's economy. There had been a significant increase in profits retained overseas by foreign subsidiaries, but Japan's tax regime resulted in the imposition of additional corporate taxes in Japan upon repatriation of those profits, thereby creating a clear disincentive to repatriate. It was felt that a failure to repatriate these profits to Japan raised the risk that R&D activities and jobs would be shifted overseas.

Second, the policymakers recognized that maintaining the competitiveness of Japan's multinational enterprises in the global marketplace would ultimately lead to additional investments in job creation within Japan and to the promotion of Japan's economy and that eliminating bias in capital flows within corporate groups was critical for this purpose.

Third, the government was deeply concerned about the increasing compliance burdens imposed by the indirect foreign tax credit system and the overall international tax regime. It is noteworthy that in adopting the foreign dividend exemption system, Japan explicitly rejected capital export neutrality as a key guiding principle in the new global business environment. Although this principle had been imported from the U.S. 50 years ago, the position of the foreign tax credit approach based upon capital export neutrality was characterized as having declined while the era of the United States as the dominant capital exporter in the world was ending.

In considering this new tax regime, Japan did not ignore potential downsides. In particular, the government was worried about the possible hollowing out of Japan's economy and shifting of jobs overseas. However, the government concluded that the adoption of the foreign dividend exemption system itself would not unduly influence corporate decisions as to whether to establish or move operations overseas.

Nevertheless, the Japanese Government implemented and continues to study a number of design features in order to cope with the risk of shifting of profits, assets, and jobs overseas. These include, for example, denying deferral for passive income of CFCs. There has also been a proposed reduction of corporate tax rates in Japan.

In addition, the government continues to evaluate potential measures to reduce the risk of outbound transfers of intangible property while encouraging R&D and related job growth in Japan. For example, it is reported that potential relief for at least some types of royalty income is being closely reviewed.

In closing, as a tax practitioner working in Asia, I have seen firsthand how nimbly America's competitors can operate within their territorial tax systems at the same time that U.S. corporations struggle to deal with the very complicated and burdensome U.S. worldwide tax regime. Your review of the U.S. tax rules, therefore, is extremely important.

Thank you.

[The statement of Mr. Thomas follows:]

**Testimony of
Mr. Gary M. Thomas
Before the
Committee on Ways & Means
U.S. House of Representatives**

**Hearing on
How Other Countries Have Used Tax Reform
To Help Their Companies
Compete in the Global Market and Create Jobs**

May 24, 2011

Chairman Camp, Ranking Member Levin, and Members of the Committee

My name is Gary Thomas. I am a partner in the law firm of White & Case LLP, based in its Tokyo, Japan office. Although I began my career after law school in the United States, I have worked in Japan now for nearly 30 years as a tax practitioner. I appear before you today on my own behalf and not on behalf of my firm or any firm client.

It is a privilege to have been invited here today to testify on how Japan has used international tax reform to assist its companies to compete in the global market, to revitalize Japan's economy by encouraging the repatriation of foreign profits to Japan, and to enhance increased employment opportunities in Japan. I believe that the Japan experience can be instructive for the Committee as it considers fundamental international tax reform for the United States.

Prior to April 2009, Japan's international tax system bore a remarkable resemblance to that of the United States. Japan imposed its corporate taxes on a global basis, including taxing dividends from foreign subsidiaries, while avoiding double tax by means of a foreign tax credit system. Japan deferred taxation of profits of foreign subsidiaries until repatriation but restricted deferral for profits of controlled foreign corporations operating in low-tax countries unless an active business exception applied. It had transfer pricing rules based upon the arm's length principle, broadly similar to the US rules under Section 482 and the OECD Transfer Pricing Guidelines.

The similarity with the US international tax regime was not surprising, because for the past 50 years, the US tax system had been the model for Japan in structuring its international tax rules.

However, on April 1, 2009, Japan moved to a territorial tax regime by adopting a foreign dividend exemption system, pursuant to which 95% of the dividends received from qualified foreign subsidiaries will be exempt from Japanese national and local corporate taxes. At the same time, Japan abolished its indirect foreign tax credit system.

Why did this substantial change occur? There were a number of key reasons.

First, the Japanese Government concluded that it was vital to encourage the repatriation of profits of foreign subsidiaries in order to assist in revitalizing Japan's economy. There had been a significant increase in profits retained overseas by foreign subsidiaries of Japanese corporations in recent years, but Japan's tax regime resulted in the imposition of additional Japanese corporate taxes upon repatriation of those profits, thereby creating a clear disincentive to repatriate. It was felt that a failure to repatriate these profits to Japan raised the risk that R&D activities and jobs would be shifted overseas, while the repatriation of the profits would encourage investment in R&D and capital as well as job growth within Japan.

Second, policy-makers recognized that maintaining the competitiveness of Japan's multinational enterprises in the global marketplace would ultimately lead to additional investments and job creation within Japan and to the promotion of Japan's economy, and that eliminating bias in capital flows within corporate groups was critical for this purpose.

Third, the Government was deeply concerned about the increasing compliance burdens imposed by the indirect foreign tax credit system. The adoption of the foreign dividend exemption system together with the abolition of the indirect foreign tax credit would relieve Japanese companies of these burdens. In particular, small and medium Japanese companies increasingly are required by market demands to establish additional operations in other countries in Asia, so reducing these compliance burdens was viewed as particularly important.

It is noteworthy that, in adopting the foreign dividend exemption system, Japan explicitly rejected "capital export neutrality" as a key guiding principle in the new global business environment. Although this principle had been imported from the United States 50 years ago, the position of the foreign tax credit approach based upon capital export neutrality was characterized as "having declined" while the era of the United States as the dominant capital-exporting country in the world was ending.

In considering this new tax regime, Japan did not ignore the potential downside of adopting the foreign dividend exemption system. In particular, the Government was worried about the possible "hollowing out" of Japan's economy and the shifting of jobs overseas. But the Government accepted as unavoidable the reality that growth in foreign markets will be significant as compared to Japan, particularly taking into account relative population growth. As a result, Japan's policy-makers concluded that it is inevitable that Japanese companies will need to continue to establish manufacturing sites and other facilities in these growing markets. However, the Government concluded that the adoption of a foreign dividend exemption system itself would not unduly influence corporate decisions as to whether to establish or move operations overseas.

Nevertheless, the Japanese Government implemented, and continues to study, a number of design features in order to cope with the risk of the shifting of profits, assets and jobs overseas. It is important to note, however, that Japan opted to move ahead quickly to adopt its new international tax regime, while continuing to monitor and improve this

system over time. As some of you may know, “kaizen” is a highly regarded business practice in Japan that focuses upon the continuous improvement of processes in manufacturing, engineering, operations, and management. The approach adopted for these recent tax reforms could be called a kind of “kaizen” in the tax field.

Consequently, for example, although Japan did not make changes to its transfer pricing rules in 2009, in 2010 it adopted into law a rigorous set of transfer pricing documentation requirements, for which a failure to comply shifts the burden of proof to the taxpayer. In 2011, the Government proposed amendments to Japan’s transfer pricing rules which would adopt the “most appropriate method” rule (in place of the earlier priority of methods) for selecting a transfer pricing method. This change is expected to make it easier for the Government to sustain transfer pricing assessments if necessary.

In addition, although not directly a Japan development, in July 2010 the OECD issued updated transfer pricing guidelines which include a new chapter concerning so-called “business restructurings” that could cover, for example, outbound transfers of intangible property. The Japanese tax authorities are currently studying these new guidelines very closely with the intention of applying them going forward.

Furthermore, in recent years, Japanese field examiners have sometimes applied so-called “donation” rules, which deny deductions for, or impute income to, corporate taxpayers, in order to deal with certain cross-border transactions which, in their view, may be difficult to address effectively with transfer pricing regulations. The criteria for applying these donation rules are quite vague, leading to considerable uncertainty for any taxpayer planning an outbound transfer of a business or intangible property. This enforcement development can have a chilling effect on potentially abusive transactions.

Another recent development has been the expansion of Japan’s tax treaty network and the conclusion of a number of tax information exchange agreements with non-treaty countries (including well known tax havens), with the intention of improving the ability of tax examiners to obtain foreign-based documentation in order to more effectively apply the transfer pricing rules.

Japan also has adopted changes to its controlled foreign corporation rules. In particular, in a departure from its historical entity approach to computing CFC profits subject to deferral, in 2010, Japan adopted measures to deny deferral for certain passive income of a CFC, even if the CFC otherwise is qualified for exemption under active business criteria.

A reduction in domestic corporate tax rates is another measure to reduce the incentive for income shifting under a territorial regime. In 2011, after carefully considering the trend among other OECD members as well as Japan’s neighboring countries in Asia to reduce corporate tax rates, the Government proposed a reduction in the overall corporate tax burden from approximately 40.7% to 35.6% (combining national and local rates). This proposal was headed for approval in the National Diet at the time of the March 11 earthquake but is now in political limbo along with the other 2011 tax reform proposals.

Nevertheless, it is anticipated by many that, at some point in the near future, the corporate tax burden will be reduced as originally planned.

The Government continues to evaluate potential measures to reduce the risk of outbound transfers of intangible property, while encouraging R&D and related job growth within Japan. For example, it is reported that potential relief for at least some types of royalty income is being closely reviewed.

Expense allocations are often raised as a concern for the introduction of a territorial tax system. As I noted earlier, Japan's foreign dividend exemption system grants an exemption for 95% of the dividends received, leaving the remaining 5% subject to taxation. This 5% is viewed as a proxy for the costs incurred to obtain and hold shares of foreign subsidiaries.

It is difficult to determine whether the changes have achieved or will achieve the objectives sought because the new regime went into effect only recently. However, preliminary data suggests that the repatriation of profits from overseas has increased considerably. For example, the Government has reported that dividend remittances increased 20% from 2009 to 2010.

In addition, reportedly, many Japanese companies have plans to increase their repatriation of profits, largely for investments in R&D and capital assets but also for repayment of debt to improve their capital positions. The recent disaster in Japan will likely make it even more imperative for many companies to repatriate profits from their foreign subsidiaries in order to fund the rebuilding of their Japan operations. However, they can now do so with considerable flexibility as their needs develop, without fear of an additional Japanese tax burden or possibly adverse indirect foreign tax credit implications.

Conclusion

With the adoption of its foreign dividend exemption system in 2009, Japan dramatically shifted direction in its international tax policy in order to encourage the repatriation of profits to further stimulate its economy, to enhance the competitiveness of Japanese multinational enterprises, and to reduce compliance burdens and costs for taxpayers.

I appreciate the opportunity to explain Japan's new tax system and hope that my remarks will be useful for the Committee in its deliberations concerning the future of the US international tax rules.

Finally, as a tax practitioner working in Asia, I have seen first hand how nimbly America's competitors can operate within their territorial tax systems, at the same time that US corporations struggle to deal with the very complicated and burdensome US worldwide tax regime. Your review of the US tax rules, while difficult and undoubtedly controversial, is therefore extremely important. Thank you.

Chairman CAMP. Thank you very much, Mr. Thomas.
We have less than 5 minutes for this vote, so we are going to recess now, and we will return and hear from the rest of our witnesses after the series of two votes on the floor. Thank you.

[Recess.]

Chairman CAMP. All right, the hearing will resume.

Mr. Schoon, you have 5 minutes, and your full statement will be made part of the record. Welcome.

**STATEMENT OF FRANK M. SCHOON, PARTNER, DUTCH DESK,
INTERNATIONAL TAX SERVICES, ERNST & YOUNG**

Mr. SCHOON. Mr. Chairman, Mr. Ranking Member, and other members of this distinguished committee, it is an honor to participate in these hearings on international tax reform.

I would like to thank you for the invitation to appear before you today to provide information on key international elements of the Netherlands corporate income tax system.

I am Frank Schoon, a Netherlands tax partner with Ernst & Young based in Chicago. I appear before you today on my own behalf and not on behalf of my firm or any client.

Corporate income tax is imposed in the Netherlands on the worldwide profits of resident entities and on the income derived from certain sources within the Netherlands of nonresident entities, with provisions to prevent double taxation. The provision used in the Netherlands to prevent double taxation is a dividend or a participation exemption, as well as a foreign branch exemption. This is generally referred to as a form of a territorial tax system.

As of January 1, 2011, the Dutch corporate income tax rate is 25 percent. Over the last three decades, the corporate income tax rates have decreased from 45 to 48 percent in the early 1980s to the current rate. From parliamentary history, it can be seen that the motivation for this decrease generally was to lower the tax burden on companies, to stimulate investment, and to create jobs, as well as to align with developments in other jurisdictions.

One of the pillars of the Dutch corporate income tax system is the participation exemption regime, which aims to prevent double taxation of business profits at different corporate levels in both a foreign and a domestic context. The origins of the participation exemption regime go back to 1893. A hundred years later, in 1992, the Dutch state secretary for finance stated during parliamentary proceedings that the exemption method, as provided under the Dutch corporate income tax system, is still the most suitable system for the Netherlands, considering its many international relations and its open economy.

The participation exemption regime fully exempts income, such as dividends and other profit distributions, currency gains or losses, and capital gains or capital losses realized with respect to a qualifying interest in a subsidiary. To qualify for the participation exemption, an ownership test and a motive test must generally be satisfied.

Under the ownership test, the taxpayer is required to hold at least 5 percent of the subsidiary. Under the motive test, the interest in the subsidiary cannot be held as a portfolio investment. The motive test is generally satisfied if the shares in the subsidiary are not held merely for a return that may be expected from normal asset management. If the motive test is not met, the participation exemption could still apply if either an asset test or the subject-to-tax test is met.

Under the current Dutch rules, expenses related to interest that qualify for the participation exemption are deductible. Several anti-abuse measures apply to limit deductions in specified circumstances. If a Dutch tax resident has a foreign permanent establishment, the income, both positive and negative, of the foreign branch will directly be included in the worldwide income of the Dutch tax resident. As a result, foreign branch losses are deductible, albeit subject to recapture. Foreign branch income is generally exempt.

The Dutch Government is currently considering moving to a full territorial tax system for foreign branch income. This would mean that foreign branch losses are not deductible and income would continue to be exempt.

Other foreign-source income, like interest and royalties, is, in principle, subject to the current statutory rate of 25 percent. However, net earnings from qualifying intellectual property, such as royalties for example, may effectively be taxed at a rate of 5 percent under the so-called innovation box regime. This regime was first introduced in 2007 to cover patents and has been expanded to cover other forms of intangible property. It was intended to stimulate development of technology, innovation, and employment in the Netherlands.

There are no special provisions in Dutch law for controlled foreign companies. In the Dutch tax system I have described, the relevant question, therefore, is whether or not the participation exemption or the branch exemption applies, which, along with the anti-abuse rules, address the issue of mobile and passive foreign income.

Thank you very much. I would be happy to answer any questions.

[The statement of Mr. Schoon follows:]

Testimony before the Committee on Ways and Means
United States House of Representatives
Washington, DC
May 24, 2011

Key Elements of the Dutch Corporate Income Tax System

Statement of Frank M. Schoon

Mr. Chairman, Mr. Ranking Member and other Members of this distinguished Committee, it is an honor to participate in these hearings on international tax reform. I would like to thank you for the invitation to appear before you today to provide information on key international elements of the Netherlands corporate income tax system. I am Frank Schoon, a Netherlands tax partner with Ernst & Young, based in Chicago. I appear before you today on my own behalf and not on behalf of Ernst & Young or any client of Ernst & Young.

In this testimony, I will provide you with a brief overview of (i) the Netherlands corporate income tax system, (ii) the history of the Dutch participation exemption regime, (iii) the current Dutch participation exemption regime, (iv) the treatment in the Netherlands of foreign branch income and other foreign source income and (v) the transfer pricing rules, advance agreements and main anti-abuse/base protection rules in the Netherlands.

The Netherlands corporate income tax system

Corporate income tax is imposed in the Netherlands on the worldwide profits of Dutch tax resident entities and on the income derived from certain specific sources within the Netherlands of non-resident entities, but with provisions to prevent double taxation of business profits. The Dutch participation exemption described more fully below generally exempts most active foreign source income earned through foreign subsidiaries.

The following types of tax-resident entities are subject to corporate income tax in the Netherlands: NV (*naamloze vennootschap*, a public limited company); BV (*besloten vennootschap*, a private limited company); companies with a capital that is, wholly or partly, divided into shares; "open" limited partnerships; cooperative associations; mutual insurance companies and associations and certain mutual funds and public bodies. Furthermore, all other types of associations, foundations and non-public bodies are subject to corporate income tax in the Netherlands to the extent that they are engaged in a trade or business. Whether an entity is tax resident is determined by reference to all relevant facts and circumstances, such as the seat of the board, the location of the head office and where the shareholders' meetings are held. Entities incorporated under Dutch civil law, such as the BV and NV, are deemed to be resident in the Netherlands for corporate income tax purposes, except for the application of a limited number of articles included in the Dutch Corporate Income Tax Act.

As mentioned, Dutch resident entities are subject to tax on their worldwide income with provisions to prevent double taxation. The taxable amount equals the taxable profit minus any losses carried over from other years. Taxable profit is equal to profit minus gifts. Profit is defined as "the total income derived from a business, in whatever form and under whatever name." This profit is then allocated to the appropriate financial years by reference to sound business practice ("*goed koopmansgebruik*") and consistent accounting conduct. The concept of sound business practice is predominantly developed in case law. The broad definition of profit allows all expenses to be deducted, unless the expenses do not qualify as business expenses (for example, if triggered by the shareholders' relationship) or a specific provision disallows deduction. One of the exceptions relates to finance costs of a certain category of "tainted transactions" (as described below), which are not deductible. Tax levied on profits is not deductible either. Distributions of profits, except for those specifically listed, whether made directly or indirectly under whatever name or form, are not deductible.

As of January 1, 2011, the Dutch corporate income tax rate on taxable profit is 20% on the first €200,000 and 25% on the remainder, regardless of whether the profits are distributed. It has recently been announced by the Dutch government that this rate may be further reduced to 24% as early as January 1, 2012. No distinction is made between capital gains and other income. In certain cases, capital gains are exempt (e.g., under the participation exemption regime) or a deferral of taxation of such gains is available based on case law or under a reinvestment reserve.

Over the last three decades the corporate income tax rates have decreased gradually from 45-48% (1980), to 40-35% (1990), 30-35% (2000), to the current rate. From parliamentary history it can be seen that the motivation for this decrease generally has been to lower the tax burden on companies, to stimulate investment and to create jobs. In later years, aligning with developments in other (EU) jurisdictions also played a role.

Resident taxpayers may claim relief for the avoidance of double taxation in respect of foreign source profits earned directly under the applicable Dutch tax treaties and the domestic Unilateral Decree rules.

Brief overview of the history of the Dutch participation exemption regime

One of the pillars of the Dutch corporate income tax system is the participation exemption regime, which aims to prevent double taxation of business profits at different corporate levels (the "*ne bis in idem*" principle) in both a foreign and a domestic context. The origins of the participation exemption regime go back to 1893. Over the years a number of amendments were made to the participation exemption regime. The latest amendment as per January 1, 2010 modifies the regime by incorporating a so-called "motive test" (as described below). This motive test aims to secure a stable approach which provides for certainty regarding application of the participation exemption.

In 1992, the Dutch State Secretary for Finance stated during parliamentary proceedings that the exemption method (for income of subsidiaries and Foreign Branches) as provided under the Dutch corporate income tax system is the most suitable system for the Netherlands considering its many international relations and

its open economy.¹

Current participation exemption regime

The participation exemption regime fully exempts income, such as dividends and other profit distributions, currency gains (or losses), and capital gains (or capital losses), realized with respect to a qualifying participation held by a taxpayer. The participation exemption also applies to profit shares owned by a taxpayer in certain debt issued by a qualifying participation that is treated as equity, as well as to options on shares of qualifying participations and earn-outs. Subject to prior approval of the Dutch tax authorities, a taxpayer can apply the participation exemption to the foreign-exchange results relating to financial instruments that hedge the foreign currency exchange rate exposure on qualifying participations.

Subject to certain very strict requirements, losses realized as a result of the liquidation of a subsidiary are not covered under the participation exemption and may as such be deducted at the level of the taxpayer.

Eligibility for participation exemption. Dutch tax resident entities and non-resident entities with a permanent establishment in the Netherlands may benefit from the participation exemption regime with respect to qualifying interests in a subsidiary.

To qualify for the participation exemption, an “ownership test” and a “motive test” generally must be satisfied with respect to the Dutch taxpayer’s shareholder’s interest in a subsidiary. If the “motive test” is not met, the participation exemption nevertheless applies if either the “asset test” (i.e., on an aggregated basis generally less than half of the assets of the subsidiary and its underlying subsidiaries consists of low taxed passive assets) or the “subject to tax test” (i.e., the directly held subsidiary is subject to a profit tax that results in a reasonable levy of profit tax in accordance with Dutch standards) is met.

Under the “ownership test” the taxpayer is required to hold at least 5% of the nominal paid-up share capital of a company with a capital divided into shares. Any interest that does not meet this 5% threshold in principle does not qualify for the participation exemption. There are, however, certain exceptions to this rule. The above capital test can be replaced by a voting rights test (i.e., the shareholder is required to hold at least 5% of the voting rights), if the subsidiary is established in an EU Member State with which the Netherlands has concluded a tax treaty that provides for a voting rights test (rather than a capital test) for the reduction of dividend withholding tax. There is no minimum requirement as to the term for which an interest in a subsidiary must be held by the Dutch shareholder in order to qualify for the participation exemption.

Under the “motive test”, an interest in a subsidiary cannot be held as a portfolio investment. Effective as of January 1, 2010, this non-portfolio requirement or “motive test” is primarily based on prior legislation

¹ Reference is also made to Paul Vlaanderen, Why Exempt Foreign Business Profits, Tax Notes International, 11 March 2002, p 1095-1103. The author states that the exemption method allows internationally operating companies to compete on an equal footing with companies in all markets of the world.

(pre-2007) and long-standing Dutch case law. Extensive parliamentary history provides an explanation of this concept and also lists some examples of when the motive test is generally satisfied. The motive test is generally satisfied if the shares in the subsidiary are not held merely for a return that may be expected from normal asset management. Some types of subsidiaries, such as fiscal investment institutions or exempt investment institutions (or foreign companies subject to a similar regime), due to their nature, cannot qualify as a non-portfolio interest. Furthermore, in a limited number of specific situations (e.g., in the case of a foreign group finance company), an interest in a subsidiary can be deemed to be held as a portfolio investment, which is generally determined based on the function and assets of the subsidiary. As noted above, if the motive test is not satisfied, the participation exemption nevertheless is available if either the asset test or the subject to tax test is met.

Non-qualifying participation exemption income. If an interest in a subsidiary does not qualify for the participation exemption under the above tests, dividends on such interest may be taxable when repatriated. In the case of income that is not eligible for the participation exemption, a foreign tax credit system applies. Under this system, a general credit is allowed for income (including capital gains) derived from such non-qualifying portfolio investment. The credit is set at 5% of such income. Alternatively, the taxpayer can choose to credit the actual underlying foreign tax, for income derived from a low-taxed portfolio investment that qualifies under the EU Parent-Subsidiary Directive.

A company that together with associated companies holds an investment of 25% or more in a non-qualifying portfolio investment which is not subject to a reasonable level of tax according to Dutch principles and 90% or more of the assets of which consist of low-taxed portfolio investments is required to mark to market this investment on an annual basis. Income derived from a non-qualifying portfolio investment is grossed up with a factor of 100/95 to subsequently apply the 5% tax credit.

Expense deductions. Prior to 1994, expenses incurred with respect to an interest in a foreign subsidiary that qualified for the participation exemption were not deductible for Dutch corporate income tax purposes, unless the expenses were instrumental in generating Dutch taxable income. The expenses to which this non-deductibility rule applied were determined using a tracing approach. Effective from January 1, 2004, this limitation on the deduction of expenses was eliminated pursuant to the ruling of the European Court of Justice in the *Bosal* case which found the limitation to be incompatible with EU law. Under the participation exemption regime as amended, expenses relating to interests that qualify for the participation exemption are deductible, such as costs for management or administration. However, expenses related to acquisition and disposal of a qualifying interest in a subsidiary, such as lawyers' and notary fees, are not deductible. Moreover, there are applicable anti-abuse and base protection rules related to interest expense, which are discussed below.

In addition, several anti-abuse measures apply to limit deductions in specified circumstances:

- If a loan to a subsidiary, which has been written off, is sold to a related person or a group company, the amount that had been taken into account as a deduction is treated as taxable income for Dutch corporate income tax purposes.

- If a loan to a subsidiary, which has been written off, is converted into an interest that qualifies for the participation exemption after the conversion, the amount that had been taken into account as a deduction is treated as taxable income for Dutch corporate income tax purposes. The write-off can be added to a revaluation reserve that is released (through a taxable recapture) as the value of the interest increases.
- Other anti-abuse measures relate to the incorporation of a permanent establishment and the treatment of losses on the liquidation of an interest that qualifies for the participation exemption.

Foreign Branch Income

If a Dutch tax resident has a foreign permanent establishment ("Foreign Branch"), the income (positive and negative) of the Foreign Branch will directly be included in the worldwide income of the Dutch tax resident. As a result, Foreign Branch losses are deductible, albeit subject to recapture. Foreign Branch income is, in principle, exempt from corporate income tax in the Netherlands under tax treaties and/or under the Dutch Unilateral Decree. According to the Dutch Unilateral Decree rules, profits derived from a business carried on through a permanent establishment or permanent representative within another sovereign country are exempt from Dutch corporate income tax provided that the foreign income is included in the resident's taxable worldwide income and that the foreign income is subject to income tax in the state from which the income is derived. The foreign income should, in principle, be taxable in the state where the income is sourced. It is not relevant whether or not the taxpayer benefits from a tax holiday for a certain period of time or whether foreign tax has actually been imposed or paid. In the absence of double tax relief, the foreign tax can be deducted as a cost at the level of the Dutch tax resident.

The Dutch Ministry of Finance is currently considering moving to a full territorial tax system for Foreign Branch income. If this system is adopted, Foreign Branch results will no longer be included in the worldwide profit of the Dutch tax resident. Furthermore, losses incurred by the Foreign Branch will no longer be deductible from the taxable income of the Dutch tax resident. Note that losses incurred by a Foreign Branch will, however, remain deductible if there is a final discontinuation of the Foreign Branch (comparable to liquidation loss rules under the participation exemption regime) and no compensation is granted by the foreign jurisdiction.

Other foreign source income

Other foreign source income like interest and royalties received by a taxpayer is in principle subject to the current statutory Dutch corporate income tax rate of 25%.

However, net earnings from qualifying intellectual property may effectively be taxed at a rate of 5% under the "innovation box". The predecessor of the innovation box, the "patent box", was introduced in 2007 and amended in 2008. Subsequently, in 2010 the regime was further modified and re-named to the innovation box. The regime was introduced in 2007 to stimulate employment and innovation in the Netherlands. A taxpayer may opt for this innovation box regime for each intangible asset that individually meets the

following cumulative requirements:

- The intangible asset is self-developed by the taxpayer
- The intangible asset is patented in the Netherlands or abroad
- It is expected that the patent will contribute at least 30% of the earnings generated from the intangible asset, and
- The intangible asset did not form part of the taxpayer's business assets prior to 1 January 2007

Agriculturists' rights in respect of newly developed plant varieties qualify as a patent. Intangible assets developed by another party for the risk and account of the taxpayer (contract R&D) can also be within the innovation box by the taxpayer.

In addition to patented intellectual property, certain designated and pre-approved assets (so-called "WSBO assets"), e.g., software, qualify for the innovation box as well. Such assets are eligible only if they did not form part of the taxpayer's business assets prior to January 1, 2008.

Self-developed trademarks, logos and other similar assets are excluded from the innovation box.

If a taxpayer opts to apply the innovation box regime, the benefits derived from a qualifying asset are taxed at an effective tax rate of 5%, to the extent that the net earnings of qualifying assets in the innovation box exceed the total amount of development costs of these assets.

Development costs of an intangible asset can be charged directly through the profit and loss account, without prior capitalization. Before the innovation box regime can be applied, the total amount of relevant development costs must be recaptured by offsetting these costs against the net earnings of all intangible assets in the innovation box. The taxpayer is required, therefore, annually to determine the amount of development costs that still needs to be recaptured.

Any losses incurred with respect to qualifying assets in the innovation box are deductible at the statutory corporate income tax rate (i.e., at 25% instead of 5%). Such losses are, however, considered development costs for innovation box purposes and are, therefore, also subject to recapture (against the statutory corporate income tax rate of 25%) before the 5% effective tax rate applies to profits derived from the qualifying assets in the innovation box. In other words, the 5% effective tax rate applies only to positive net income that falls within the innovation box.

The amount of "net earnings" is the balance of all revenue, including capital gains, less the costs of amortization and other costs connected to the qualifying intangible assets and WBSO assets within the innovation box. In other words, the earnings are not merely limited to formal royalty income but basically all benefits connected to the qualifying assets could be within the innovation box (i.e., an economic concept of earnings). The total amount of net earnings from qualifying assets which could be taxed at the 5% rate is unlimited.

Foreign withholding taxes borne by a resident taxpayer can under the available tax treaty, in principle, be

credited against the Dutch corporate income tax irrespective of whether the income is taxed in the innovation box (subject to a two-tier limitation).

Transfer Pricing Rules

As of January 1, 2002, the arm's length principle was codified following the OECD Transfer Pricing Guidelines. This principle ensures that related-party transactions must be agreed on the same terms and conditions as third-party transactions. Before 2002, this principle originated from the basic concept that taxable profit comprises all income derived from a business, in whatever form and under whatever name. As a consequence of this principle, any payment or benefit made or paid directly or indirectly to a person in his or her capacity as shareholder, or made or paid to related persons under conditions that are not at arm's length, will be construed as distributions of profit in full or in part to the shareholder. However, such a distribution of profit is not deductible and dividend withholding tax may apply.

Conversely, if a related company grants a benefit to a Dutch company, which originates from the shareholders' relation as opposed to deriving from a business, such a benefit does not fall within the scope of the Dutch corporate income tax. Such a benefit is construed as a capital contribution in disguise or "informal capital contribution," which must be excluded from the taxable profit of the company.

The relevant rules refer to a broad set of relationships with respect to which the arm's length principle must be satisfied. It also covers a board relation or a control relation. In this respect, it is of importance whether the shareholder, board member or supervisor is able to influence the transfer pricing of the companies involved.

For taxpayers, it is mandatory to document intercompany transactions. The documentation has to be available as of the moment of the first intercompany transaction. If a taxpayer is not able to submit the documentation, the burden of proof is reversed, and the taxpayer must demonstrate, to the satisfaction of the tax authorities, that the transfer pricing is at arm's length.

Advance agreements

Often taxpayers discuss their tax position in advance with the Dutch tax authorities in order to settle any uncertainties and avoid disputes. In many cases this leads to an advance pricing agreement ("APA") or other agreements.

Anti-abuse/base protection rules

Anti-avoidance measures are incorporated throughout Netherlands tax law, applicable EU Directives and tax treaties concluded by the Netherlands.

The most relevant anti-base erosion rules as stated in the Dutch Corporate Income Tax Act of 1969 are the thin capitalization rules and the interest deduction limitation rules, which are briefly described below.

The thin-capitalization rules are designed to avoid the erosion of the Dutch tax base within corporate groups. Under the rules, interest expenses (and other costs) with respect to related-party loans (or deemed related-party loans) may be partly or completely disallowed if the taxpayer is part of a group, as defined in the Dutch Civil Code (in general, comparable to the definition under Dutch generally accepted accounting principles [GAAP]/international financial reporting standards [IFRS]) and if the taxpayer's debt level exceeds specified thresholds.

Under the rules, if the average fiscal debt of the company exceeds three times the company's average fiscal equity plus €500,000, the excess interest is in principle disallowed. However, as an alternative, the company may look at the commercial consolidated debt-to-equity ratio of the (international) group of which it is a member. If the company's own commercial debt-to-equity ratio does not exceed the commercial debt-to-equity ratio of the group, the tax deduction for interest on related-party loans is allowed.

In principle, deductions for interest on external (bank) debt directly obtained by the taxpayer are not disallowed. However, if such external debt is formally granted by a third party but is in fact owed to a related party, the thin-capitalization rules apply.

Under the interest deduction limitation rules, the deduction of interest paid, including related costs and currency exchange results, by a taxpayer on a related-party loan may be disallowed if the loan relates to one of the following transactions:

- Dividend distributions or repayments of capital by the taxpayer or by a related Dutch company to a related company or a related individual
- Capital contributions by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands into a related company
- The acquisition or extension of an interest by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands in a company that is related to the Dutch tax resident after this acquisition or extension

However, this interest deduction limitation does not apply, and the deduction is allowed, if either of the following conditions is satisfied:

- The loan and the related transaction are primarily based on business considerations; or
- At the level of the creditor, the interest on the loan is subject to tax on income or profits that results in a levy of at least 10% on a tax base determined under Dutch standards. In addition, such interest income may not be set off against losses incurred in prior years or benefit from other forms or types of relief that were available or anticipated when the loan was obtained. Effective from January 1, 2008, even if the interest income on the loan is subject to a levy of at

least 10% on a tax base determined under Dutch standards at the level of the creditor, interest payments are not deductible if the tax authorities can demonstrate it to be likely that the loan or the related transaction is not primarily based on business considerations.

For purposes of applying this interest deduction limitation, interest expenses are traced on a historic basis. A mathematical method of allocation is not used for this purpose.

Finally, it has been announced by the Dutch government that deduction of excessive interest expenses incurred by a Dutch acquisition company which is subsequently joined in a fiscal unity (i.e., a tax consolidation) with the acquired Dutch target company will be limited. This provision would apply to both related party and third party debt. In addition, it has been announced that the deduction of interest costs related to the acquisition of interests qualifying for the participation exemption will be reviewed.

Absence of controlled foreign corporation rules

There are no special provisions in Dutch law for "controlled foreign companies" (i.e., there are no controlled foreign corporation or Subpart F rules). In the Dutch tax system as described above, the relevant question therefore is whether or not the participation exemption or the branch exemption applies, which along with the anti-abuse and base protection rules address the issue of mobile and passive foreign income.

Thank you for giving me the opportunity to share this information on the Netherlands tax system. I would be happy to answer any questions from Members of the Committee.

Chairman CAMP. Thank you very much.

Mr. Edge, you have 5 minutes, and your full statement will be part of the record, as well.

**STATEMENT OF STEPHEN EDGE, PARTNER,
SLAUGHTER AND MAY**

Mr. EDGE. Thank you.

Chairman Camp, Ranking Member Levin, Members of the Committee, I, too, am pleased to be here today, and I hope that I can help you in your deliberations.

First of all, let me apologize for the length of my testimony. As you will see, we have been on a long journey in the U.K., and I thought it would be interesting for you to see some of the very open Revenue consultations that there have been which tell the full story of what the revenue in recent years have been calling “a direction of travel”.

As I acknowledge in my paper, tax is an important business consideration, but it is not the most important. Logically, one might say that the best tax rate for a corporate tax lawyer is zero, but we know that that is not practical politics. This is not, as some people have suggested, a race to the bottom. It is a question of finding the right balance between the tax rate that is fair for business and will enable it to compete and that is fair to the society that is imposing that tax.

As the U.K. has gone along its direction of travel, Three pressures have emerged, and I deal with those in my testimony.

The first is obviously government pressure. Government needs to raise funding to provide the infrastructure that business needs in which to operate and to provide all the facilities its people need. It also needs to be cognizant of the fact that tax can be a great disincentive to investment.

Secondly, industry. A huge amount of industry pressure, as you will see from my paper, followed the 2007 consultative document in which the government sought to extend the scope of our CFC rules so that they resembled what I remember of your SubPart F rules in the early 1980s, Propensity to tax offshore passive income regardless, resulted in many U.K. companies saying, well, if that is the way the U.K. system is going to be, we will leave the U.K. The U.K. does not have and cannot have anti-inversion rules. And as I explained in my testimony, the effective tax rate is absolutely key if a multinational is going to compete and is going to continue to grow.

Thirdly, we have the pressures that are connected with the EU freedoms which say that, if you are within the EU, your laws can't distinguish between the investment that you might make elsewhere in the U.K., buying shares in a company in the north of England, and an investment that you might make in a Spanish/French/German company. So if you have a 100 percent domestic exclusion on dividends, you must have it if a dividend is coming in from elsewhere in the EU. And, equally, if you don't have CFC rules within your domestic regime, of course, then, you can't have them internationally.

But, as I say in my paper, although you could say that the EU rules forced us in the direction of conforming to an exemption system, that, I don't think, was the main driver. The main driver, as the consultation showed, for where we have got to now, which is an exemption system with no interest allocation and severely pared-down CFC rules compared with what we have had in the past, is that there is perceived to be an identity of interest between government and industry in maintaining our national champions. Multinationals are perceived to be good things and to contribute things to the U.K. which we would prefer to have.

The government has been brave and said that we should not have a tax system that distorts good business decisions. If people

want to invest somewhere else, they should be free to do so, and the U.K. tax system should not then take away an overseas tax advantage that is part of the total picture as to why someone invests overseas. And we shouldn't create penalties when somebody repatriates cash which might be a barrier to investment in the U.K.

Of course, industry, in its desire to achieve an effective tax rate that is low, has to be conscious of its obligations. There is more pressure now in the U.K. on social responsibility in tax. And base erosion has been a key part of this process. As I say in my testimony, the U.K. decided not to have interest allocation or restrictions. That decision, I think, could have gone either way and will be kept under review. The CFC rules, or course, are a key feature in the territorial system. We are trying to be sensible on those and only tax income within a CFC if there is clear evidence of avoidance or diversion. And in order to make the U.K. comparatively a more attractive place to invest, we have lowered the domestic tax rate, which is targeted to come down to a 23 percent rate by the end of this parliament.

So we are on a long journey. I hope we are proceeding to a successful conclusion. Thank you.

[The statement of Mr. Edge follows:]

**Testimony of
Mr Stephen Edge
Before the
Committee on Ways and Means
U.S. House of Representatives**

**Hearing on
How Other Countries Have Used Tax Reform
To Help Their Companies
Compete in the Global Market and Create Jobs**

May 24, 2011

Chairman Camp, Ranking Member Levin and Members of the Committee.

Personal Background

1. My name is Stephen Edge and I am a qualified solicitor specialising in corporate tax in the UK.
2. I appear before you today on my own behalf and not on behalf of my firm or any client. The views I express reflect my own perspective of a complex world based on my own personal experiences. I acknowledge that others may have a different perspective.
3. My formal legal education commenced with a Law Degree from Exeter University, England in 1972.
4. I joined Slaughter and May in 1973, after a six-month course leading to successful completion of what, in US terms, are effectively the bar exams, and then spent two years doing practical work experience (now called a training contract, then called articles) before qualifying as a solicitor in 1975.
5. On qualifying, I joined the Tax Department of which I have been a member ever since. I became a partner in the firm in 1982.
6. It is a privilege to have been invited here to testify on how the UK has responded to a number of external pressures by setting itself the objective of giving the UK "the most competitive tax system in the G20".

Current Practice and Past Experience

7. My practice has always spread across the full range of UK corporate taxes in a multinational context. My firm acts for large multinationals, whether based in the UK or elsewhere, and is involved in complex transactions in either the financing or M&A area. The Tax Department supports this effort and also has its own tax consultancy clients (many of them multinationals). I personally act for a number of large UK multinationals - and have, for many years, advised a number of overseas (principally US) multinationals too. In the course of my work, I have spent a great deal of time over the years in policy discussions with HM Revenue & Customs (HMRC) and government - and also, of course, in tax controversies which test the limits of, and underlying policies behind, tax legislation.

8. My M&A experience means that I have been involved in very many discussions about the impact of tax on corporate acquisitions or disposals and, in particular, on the impact that various tax attributes can have on the economics or pricing of a deal.
9. This has often, of course, involved discussions between parties to a merger as to where the new group holdco should be located - in relation to which tax is an important but not usually a conclusive factor. There are many other aspects to be taken into account in deciding where a holdco should be located but, all other things (such as corporate governance, the practical aspects of staff location, capital markets etc) being equal, corporates will usually, of course, choose the most benign or accommodating jurisdiction in tax terms.
10. Although my qualifications and the work of the firm restrict the formal advice I give to the UK tax and legal aspects of a transaction, I do of course regularly deal, and exchange ideas, with practitioners from other jurisdictions and I am, therefore, aware of what is being done in the multinational tax area in a number of other developed jurisdictions (particularly the US and other countries in Europe).

Focus of Testimony

11. In this testimony, I will be focusing on: -

- (a) the impact the domestic tax regime can have on multinationals;
 - (b) the areas in which jurisdictions try to compete with each other to make themselves more attractive in tax terms to multinationals; and
 - (c) in particular, recent thinking behind the introduction of an exemption system in the UK on foreign dividends and the decision not to introduce additional rules relating to the allocation of interest or other overheads connected with a foreign acquisition. (I say "additional rules" here because, like many jurisdictions, the UK has provisions which prevent corporates taking deductions for expenses that do not "belong" in the UK because they do not relate to a UK trade or business. It has transfer pricing rules which ensure that proper charges are made for services provided to affiliates and there is also a plethora of interest related tax avoidance rules).
12. There are, of course, other areas of tax law which are directed at influencing business decisions as regards the UK (such as tonnage tax for shipping, the new patent box for R&D businesses and accelerated depreciation for capital investment) but they are not relevant in this context.

What a Competitive Tax Regime for Multinationals Requires

13. A competitive tax regime for multinationals is what the last two UK governments have said they are aspiring to create. The key features of any multinational tax regime, when comparisons are being made between different jurisdictions, are:
- (a) the existence or otherwise of withholding taxes on distributions to shareholders;
 - (b) the domestic tax rate (as it applies not only to domestic trading profits but also to income derived from international operations in the form for example of management charges, consideration for the use of IP and returns on funding provided to overseas subsidiaries);

- (c) the scope and effect of any interest allocation rules or other restrictions affecting overseas investments;
 - (d) the treatment of overseas dividends - whether there is an exemption system on foreign dividends or a foreign tax credit system;
 - (e) the fact that the jurisdiction offers a good tax treaty network so as to reduce withholding taxes and other tax restrictions on remittances of profits from overseas;
 - (f) the existence or otherwise of a good participation exemption covering capital gains on realisation of investments in subsidiaries or on the repatriation of capital from overseas; and
 - (g) the impact of any controlled foreign company (or CFC) rules.
14. In terms of managing any multinational's effective tax rate (and also producing tax synergies from any acquisition or merger) the most important of these would obviously be (a) the domestic tax rate (b) the existence or otherwise of interest allocation rules (c) the tax position on the remittance of profits and (d) the scope of any CFC rules. These will, therefore, be the particular areas of focus in this testimony.

Recent UK Developments

15. In recent times, the UK has:-
- (a) reduced its domestic corporate tax rate with a commitment to reach 23% by the end of the current parliament. (At Appendix A, I show what the UK corporate tax rates have been since corporation tax was introduced in 1965);
 - (b) after full consideration, decided not to introduce further interest restrictions and, in particular, not to follow the model recently introduced elsewhere in Europe of restricting allowable interest expense to a percentage of locally taxable income;
 - (c) changed from a foreign tax credit system to an exemption system on foreign dividends (2009); and
 - (d) introduced what is effectively a participation exemption on disposals of shares in companies which are trading or part of a trading group (the Substantial Shareholding Exemption (SSE) regime introduced in 2002).
16. The UK has a good double tax treaty network and has had no withholding tax on outbound dividends since the Advance Corporation Tax (or ACT) system was introduced in 1972.

UK's Position in the Commercial World

17. The UK obviously has an important financial centre and key positions in other related businesses. For its commercial and industrial base, the UK has operated successfully for many years on the basis of (a) a mercantile economy with (b) very open capital markets.

18. Having a mercantile economy means that the UK encourages its business community to stay in the UK and gives incentives for others to establish themselves and/or invest here. Business flexibility - and, of course, all the other attributes that can be offered through UK corporate governance, infrastructure etc - have been seen to be key in this regard. You need to have the right general environment for tax to become a potential swing factor. Like any market place, you first have to attract the traders to set up business and then make it attractive for people to come to the UK and do business with them.
19. Open capital markets mean that, subject to competition restrictions, there is no reason why a UK public company cannot be taken over and reorganised by a foreign competitor. By the same token, both EU law and natural UK inclinations mean that UK companies are free to move their corporate residence offshore. Again, this creates an enterprise economy which must encourage business in order to be successful. The decision (subject to competition restrictions) on any takeover bid or on whether companies should continue to be parented in the UK or move their residence or be acquired by a non-resident third party acquirer is left entirely to commercial and capital markets considerations.
20. Having said that, the UK has a natural desire to retain (and, if possible, increase) the large number of multinationals that are currently based in the UK, whether or not they carry on significant operations here. It has thus gone to some trouble to attract other jurisdiction's multinationals to set up business in the UK and to base their headquarters here.

Efforts to Encourage Multinationals to Operate In UK

21. As will be seen from Appendix A, corporate tax started off at a 40% rate when it was introduced in 1965. In 1972, some radical changes were made to the system so that the rate went up to 52% but withholding tax on dividends was eliminated and instead the ACT system was introduced.
22. This meant that companies had to make a payment on account of their own tax liabilities when they had paid a dividend. That payment then served a double duty - first, it was offsettable against a company's own tax liabilities when they arose and second it "franked" or, in financial terms, covered the tax credit that was given to the shareholders which could be offset against their own liabilities or repaid.
23. There were two key problems with this: -
- (a) the first was that there was a significant cost for inward investors (particularly from the US) who had benefited from a reduced withholding tax rate under the treaty (taking the UK tax take on remitted profits down to around 43%) but would not be able to benefit from the ACT credit. This was amended by ACT credit refunds under the new US/UK treaty negotiated in 1975 which provided for an incremental dividend linked return to incoming US multinationals and at the time maintained the effective 43% rate; and
 - (b) the fact that ACT had to be paid regardless of whether or not taxable profits arose in the UK gave rise to a considerable cashflow cost for multinationals based in the UK whose income was mainly sourced from overseas so that, after foreign tax credits, they had no domestic tax base. (It had a similar effect, of course, on loss making companies whose operations were wholly carried on in the UK). The multinational community complained about this provision of "permanent interest free finance" to the government for many years.

24. In 1994, a consultation on the ACT system produced some modifications through the introduction of international holding companies (IHC's) and a special form of dividend (foreign income dividends or FID's) which enabled UK based multinationals with substantial amounts of overseas income to pay through dividends that were not subject to ACT and so avoided the cost of paying UK taxes they might not recover. This was a deliberate attempt by the government at the time to continue to maintain UK tax competitiveness in the multinational arena
25. In 1997, the domestic impact of repayable tax credits to pension funds and others meant that the incoming government took steps to abolish the ACT system completely - though interestingly the corporate tax rate was not then restored to its previous level and nor were withholding taxes reintroduced. A low tax rate on corporate profits and no further tax on distribution were seen as major advantages of operating in the UK.

Previous Consultation on the Treatment of Foreign Dividends

26. In 1999, the government consulted on whether or not an exemption system for foreign dividends should come in. It was feared by most UK multinational tax directors at that time that an exemption system could only come in if there were interest restrictions and they concluded that a tax credit system with no interest restrictions was better than an exemption system with interest restrictions. The status quo was thus maintained.

Parallel Developments through the European Court of Justice

27. On a parallel track during the 1980's and 1990's, the impact of the European freedoms on domestic tax law as it affected multinationals based in the UK was being explored through the courts. Two particular cases were relevant in this area: -
- (a) the **Cadbury** case (*Cadbury Schweppes plc and others v Inland Revenue Commissioners* (Case C-196/04) [2006] ECR I-7995) which said that the UK could not impose CFC rules on UK groups which had properly and fully established business operations in another European country without contravening the fundamental freedoms by creating a differential between domestic and overseas investment; and
 - (b) the **FII** litigation (*Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners* [2010] EWCA Civ 103) which broadly said that the UK could only have a domestic exemption system on corporate dividends and a foreign tax credit system on overseas dividends if "the two did the same thing." Since the domestic exemption system (which had been a feature of corporate tax since inception) accorded the exemption regardless of whether or not there were any underlying taxes, this clearly meant that the UK had to conform the treatment of domestic and corporate dividends.
28. Resolving these two disputes, where HMRC pursued litigation to defend its position vigorously, clearly presented the government with some policy challenges going forward - and also some potential exposure in relation to taxes still disputed for past periods. In theory, the disputes could have been resolved by conforming UK law and practice with the then current foreign practice but that would have had severe practical problems so the disputes rumbled on for a period.

CFC Aspects

29. For several years, multinationals filed on the basis that Cadbury was good law in the UK (European law having direct effect regardless of what the UK's statute said) and there was an effective stand off between multinationals and the government. Matters with the UK multinational community came to a head in 2007 when a consultative document (*"Taxation of the foreign profits of companies" June 2007*) attached as [Exhibit I](#) proposed "modernising" the treatment of the UK CFC regime in a way that many thought was not consistent with Cadbury and saw as intended to increase the UK corporate tax yield by taxing offshore passive income received by CFC's of UK multinationals.
30. The reaction to this was quite extreme - some companies emigrated and left the UK (see [Appendix B](#)) but others said that they were only going to stay if the CFC rules were not only made to comply with EU rules (as Cadbury required) but were also made more competitive in global terms.
31. The government's response to this was to seek to pacify the UK multinational community so that they would stay in the UK by promising to deliver a more competitive system and address, in particular, the CFC concerns that had been raised. In taking this position, the government was, no doubt, well aware of the fact that EU law prevented them introducing something similar to the anti-inversion rules in the US.
32. Consultation with business on an open and active basis has radically improved. As a result, discussions on CFC reform took place during the final years of the Labour government and have continued in the first year of the new Coalition government.
33. The Coalition government has now proposed the introduction of limited reforms of some significance, under which (inter alia) offshore treasury companies are allowed to pay effectively a low rate of tax (equity funding being permitted up to 75% of their capital base) and has promised more to follow. (The patent box was part of this package).

Dividend Exemption

34. In 2009, the decision was made that conforming domestic and foreign dividend treatment by exempting most corporate dividends (with some limited tax avoidance related exemptions) would be the answer both to EU law pressure and to the clamour from the multinational community for a more competitive UK tax system for multinationals. Legislation was introduced to bring this into effect. This contained no interest allocation rules - though I discuss below the introduction of this at the same time of a worldwide debt cap.

Corporate Tax Rate Reductions Continued

35. Within a short period of taking office, the Coalition government announced that the domestic tax rate is to be reduced progressively over the period of this parliament to 23%.

Consideration of Interest Allocation or Other Similar Restrictions

36. When the domestic tax rate discussions were taking place, there was considerable discussion as to whether or not this should be accompanied by interest allocation restrictions (perhaps along the German lines). There was, however, a clear policy decision by the government (*"Corporate Tax Reform: Delivering a More Competitive System" November 2010* attached as [Exhibit II](#)) that the fact that the UK had no interest restrictions was an attractive part of the multinational package and should continue.

37. It could have been said, of course, that the UK already had more than adequate protection against "debt dumping" or excessive or inappropriate UK interest deductions. There are longstanding rules which differentiate between debt and debt which has equity-like features. The UK has had thin capitalisation rules for over 30 years now. In 1996, a specific anti-avoidance rule for interest expense was introduced (looking at the purpose of a particular borrowing). Finally, more recent legislation has been introduced to deal with hybrid debt in circumstances where tax is driving the transaction (2005) and a so-called worldwide debt cap which seeks to ensure that UK parts of a global group do not have more debt than the group as a whole (2009). (Interestingly, the worldwide debt cap rules were primarily directed at upstream loans - of which more below.)

Other Protections Against Profit Diversion

38. In terms of protecting the UK tax base (whether under the existing regime or in previous times when we did not have an exemption for offshore dividends), transfer pricing and exit charge provisions prevent UK companies entering into artificial transactions with overseas affiliates or transferring assets at less than market value to overseas affiliates.
39. As already mentioned, the UK also has rules which prevent UK companies taking a deduction for expenses that do not really relate to its business - so employing the senior management of an overseas affiliate in the UK and trying to deduct the expense whilst not recognising any income would be problematic under those rules even if it were not caught by the transfer pricing provisions.

The CFC Implications - History

40. Remember, first of all, that the government faced two pressures when this process began - one was to meet the demands of the UK multinational community after the 2007 furore and the other was to make UK law conform with European law (which, as already mentioned, could be done in one of two ways).
41. I will deal first of all with the history in order to put the discussion that follows into context. In 1984, when the CFC rules were introduced for the first time, provisions were put in to counter transactions where companies with so-called passive or artificially manufactured income offshore did not remit it to the UK. This would catch royalty income, financing income, some intra group transactions and some foreign holding companies. A number of exemptions were built into the CFC rules when they were introduced so that, as was said at the time, they would be operated as anti-avoidance rules only and would not impinge on normal corporate operations. With that in mind, they were limited to income profits and not capital gains - and still are.
42. Inevitably, however, things moved in a different direction over time. First, taxpayers and their advisers manipulated the rules so as to "hide" some offshore income that might otherwise be vulnerable to apportionment under the CFC provisions. The tax authorities also began to broaden the scope of the rules in response to such perceived abuses and also faced with general tax gathering pressures.
43. This all came to a head in 2007, as mentioned above, when taxpayers perceived that there was a clear attempt to extend the scope of the rules so that they picked up all foreign passive income or returns from mobile capital regardless of the underlying motivation and also without regard to limitations imposed under EU law.

The CFC Implications - Recent Changes

44. As will be seen, the CFC rules (whether by virtue of their incompatibility with EU law, litigation on which was really just a symptom of the general discontent, or because of their impact on UK based multinationals' ability to manage their effective tax rate) have been at the heart of the debate between UK business and government over the last few years – but the foreign dividend exemption and interest allocation (which are, of course, related topics) were never far away from the debate.
45. All these matters then had to be brought to a head in reaching a compromise in relation to past disputes and building a competitive regime for the future that met both the government's and the business community's objectives.

How to Deal with Existing Overseas Cash Balances

46. In a period when, in order to maintain a competitive effective tax rate, UK groups had naturally built up offshore passive income which was lowly taxed and balanced out higher taxes paid in downstream jurisdictions where they were operating in averaging out their global rates (usually somewhere in the 20-30% range), large amounts of overseas cash had built up in the period after the UK abolished exchange controls in 1979. There was no way of forcing UK companies to repatriate that cash. The CFC regime was the only mechanism available to the tax authorities. But it was only effective in periods in which income accrued.
47. (It is not always the case, of course, that offshore surplus cash is income that is simply not being dividended back to the UK. With many groups, offshore cash balances may arise from one disposal and may be held in anticipation of another future acquisition. Requiring a UK group to bring any overseas cash back to the UK and pay tax on it before re-investing it offshore obviously creates tax friction in a multinational's operations.)
48. Many UK groups had, prior to the exempt dividend rules coming in, thus lent overseas surplus cash in one part of their overseas group to another part of their group where it was needed. Often such cash was lent back to the UK (where the main treasury operations might be located). The UK has never had corporate tax rules which have re-characterised such an upstream loan as a dividend.
49. In HMRC's eyes, upstream loans not only brought the cash here without an income charge but they also created a deduction which eroded the UK tax base. That second point could have been dealt with through existing anti-avoidance rules in extreme cases but it was finally addressed when the worldwide debt cap rules came in.

Transition to Exemption

50. At the time of the discussions about dividend exemption, the existence of overseas cash balances was thus well known to both sides in the debate and the question arose as to whether there should be some division between past profits and future profits. There was clearly concern within government that past untaxed profits should not be brought back tax free, especially when they might be the fruits of CFC planning. Many commentators pointed out, however, that the idea that the government would collect tax on those unremitted amounts was illusory. Unless there was a sensible settlement on the CFC rules, many large groups would leave the UK (the threat was a real one) and so those overseas unremitted profits would never, in fact, be repatriated. The government decided, probably for practical reasons, to make no distinction.

Acceptance of Territoriality as the Guiding Principle

51. Out of all this emerged the concept of territoriality as the guiding principle to a settlement. The decision was that the UK should only tax income arising within its territory unless there was evidence of abuse. That abuse would be protected through existing rules (the transfer pricing regime etc) and also through a CFC regime which would deal with "artificial diversions of profits" in a way (yet to be fully disclosed) that complied with EU rules.
52. This was a key step along the road towards the currently proposed regime, which UK business seems inclined, subject to seeing the final detail, to accept as enabling it to compete globally with other companies in similar business areas who have effective tax rates lower than UK multinationals.
53. (As many multinationals have argued, without a competitive effective tax rate, companies are unable to deliver shareholder returns that match those of their overseas competitors. They are also often unable to make acquisitions when faced with competitors who apply a lower tax rate to income that they are acquiring and can thus afford to pay a higher purchase price. Any multinational which stops growing will eventually become vulnerable to take over itself. In the past, UK companies who have been taken over have found that their operations have been restructured so that areas of the group which were a problem in UK CFC terms are moved "out of harm's way" - producing tax synergies for the purchaser.)
54. The decision on interest apportionment could clearly, in theory, have gone either way - but the basis of the decision was to encourage (within reason) overseas enterprise when that made more business sense than domestic expansion. The government will obviously keep a weather eye on this situation to see how the policy performs.
55. The decisions on CFC amendment and dividend exemption go hand in hand. They could be characterised purely as a response to the EU playing field levelling. But, as already mentioned, other solutions to EU compatibility were theoretically available (more clearly on dividend exemption). So, the better view must be that this is a genuine desire to have the most competitive G20 regime.
56. Having said that, of course, tax is only part of the total package that any business will consider in making investments or locating itself. What the government has tried to do is take tax out of the equation when those decisions come to be made. A low tax rate may assist domestic growth - but, if other factors point in favour of overseas expansion, the UK tax system will not discourage that in tax terms by seeking to cancel out the overseas benefit.
57. Finally, a major factor in business's willingness to trust government when it promised to deliver on international tax reform was the much improved relationship between HMRC and the taxpaying community. Greater transparency and openness has had benefits for both sides.

Conclusion and Balance of Views

58. There is no standard or perfect tax system. Politics and economics will mean that each jurisdiction has different constraints and objectives.
59. There are some who would say that multinational companies have too much influence with government and that the currently proposed system in the UK discriminates against companies with wholly domestic operations who might be seen to pay higher effective tax rates on their total profits than those who engage in multinational operations and can thus benefit from lower overseas rates. By making multinational companies pay more UK tax on their overseas profits, they would argue, the incentive to divert profits

overseas and employ people overseas rather than in the UK would be removed. Any other system is "unfair" in their eyes.

60. Those (including me) who support the current system see it as a pragmatic response to the practicalities in a world where competition is fast moving and truly global. As already mentioned, the European problems could, in theory, have been resolved in a different way. What has, therefore, driven the UK towards this solution is the desire to enable its national champions to compete and also, in the mercantile tradition, to attract more multinationals to conduct their operations from the UK. Commentators have pointed out that a company's tax contribution to an economy should not just be measured by references to corporate taxes paid.
61. Successful companies in the UK are likely to want to grow overseas and, if they do so, they will eventually become multinationals. If the UK has a regime which encourages multinationals, then its national champions will flourish and that should, it is argued, be to the benefit of the UK economy. The alternative with an open economy like the UK's is to see multinationals grow in other jurisdictions because your own are made uncompetitive and then have to face the possibility that your own corporate base in the UK becomes controlled by multinationals operating from other jurisdictions and with their own business agenda.
62. There were clearly a whole host of political and economic decisions that underpinned the eventual decision but the competing arguments were clear. They were resolved in favour of a more competitive regime, leaving UK based multinationals to pay the same rate as everyone else on their UK corporate profits but not have to face UK charges on overseas profits unless and until remitted in non-tax exempt form (i.e. not as dividends or as a capital repayment exempt from tax under the SSE regime). UK based multinationals were, therefore, put in a position where, if the business case supported this, they could expand overseas without necessarily having to worry about the UK tax implications.
63. Any government will obviously be concerned to protect its domestic tax base but, as explained above, it looks as if there are protections in place in the UK to do that already - and further are envisaged under the full CFC amendments when they are introduced.
64. (In some ways, the current regime harks back to previous UK regimes where foreign income was only taxed when remitted and could otherwise remain outside the UK tax net)

Appendix A

United Kingdom corporation tax rates since 1965	
Year	Standard rate
1965-69	40%
1969-70	45%
1970-71	42.5%
1971-73	40%
1973-83	52%
1983-84	50%
1984-85	45%
1985-86	40%
1986-90	35%
1990-91	34%
1991-97	33%
1997-99	31%
1999-08	30%
2008-11	28%

Source: *The Institute for Fiscal Studies*.

Appendix B

HMRC figures would suggest that 22 companies left the UK specifically for tax reasons since 2007/08. Of those that emigrated a few were prominent business including the advertising company WPP, publishing firm UBM, and pharmaceutical company Shire. Several of those that left were likely to be FTSE100 or FTSE250 companies which may have paid significant amounts of UK tax.

The HMRC figures will not, of course, take into account figures of companies which would have considered setting up in the UK but did not as a result of unfavourable tax changes. In addition, the figures are only likely to capture companies which declared to HMRC (or to the public (as in the case of Shire, UBM and WPP)) their intention to leave for tax reasons. It is quite evident that the majority of companies would not make a specific declaration to HMRC that they are leaving the UK for tax planning reasons and there is no such requirement for them to do so.

Companies leaving the UK specifically for tax reasons	
Year	Number of companies that emigrated
2007/08	1
2008/09	10
2009/10	7
2010/11	4

Source: HMRC.

OC 006134/007/AME

Chairman CAMP. Thank you very much. Thank you for your testimony.

Mr. Menger, you also have 5 minutes, and your written testimony will be part of the record, as well.

**STATEMENT OF JÖRG MENGER, PARTNER, GERMAN DESK,
INTERNATIONAL TAX SERVICES, ERNST & YOUNG**

Mr. MENGER. Mr. Chairman, Mr. Ranking Member, other members of this distinguished committee, thank you for your honor to participate in this hearing on international tax reform.

I am Jörg Menger, an international partner of the German firm of Ernst & Young currently on assignment in New York. I appear before you today on my own behalf, not on behalf of my firm or any client. The purpose of this statement is to provide a brief overview over the German corporate tax system, in particular the tax treatment of foreign-source income.

German tax policymakers have long focused on the implementation of a system of foreign-source taxation which is governed by the principle of capital import neutrality, which is aimed to ensure that German companies are able to compete in foreign markets against local companies.

The German corporate tax rate—the German corporate tax includes corporate income taxes and trade taxes. The current combined average tax rate is slightly below 30 percent. The current tax rate reflects a series of reforms which has reduced the corporate tax rate from as high as 65 percent.

To avoid double taxation on corporate earnings distributed within a chain of corporations, the German corporate tax law employs an exemption systems on dividends distributed from one corporation to another corporation. Generally, 95 percent of any dividends received by a corporation are tax-exempt; thus, only 5 percent of the dividend income is included in the taxable income.

The tax policy rationale for the 5 percent income inclusion is to act as a compensating offset for the deduction of business expenses which are directly related to the exempt dividend income. The implementation of the 5 percent inclusion rule ended a constant conflict between the German taxpayer and the German tax authorities with regard to the interest deduction.

A brief overview of the history of the international German tax system should provide an insight into the current tax policy. Beginning in the 1950s, dividends distributed by foreign corporations to German corporations were exempt from taxation pursuant to the tax treaty provisions. This 100 percent exemption was combined with a rule that disallowed deductions on certain expenses which were directly related to the shares owned in the distributing company and were determined using the tracing approach. Since 2001, the treaty-based rule on dividend and capital gain exemption was replaced by a 95 percent exemption, and this applies both to foreign and domestic shares.

Germany has foreign corporation rules which subject undistributed income of controlled foreign companies to a full German corporate and trade tax, but only if such income is both passive in nature and low-taxed. Moreover, the CFC rules do not apply to EU subsidiaries if the subsidiary carries on an own business activity.

In summary, Germany has incorporated its territorial tax system in the tax treaty network and the Tax Code with special rules for low-tax passive income. This approach was guided by the principle of capital import neutrality and simplicity.

Thank you, and I am happy to answer any questions.

[The statement of Mr. Menger follows:]

Testimony before the Committee on Ways and Means
United States House of Representatives
Washington, DC
May 24, 2011

Key Elements of the German Corporate Tax System

Statement of Jorg Menger

Mr. Chairman, Mr. Ranking Member and other members of this distinguished Committee, thank you for the honor to participate in these hearings on international tax reform. My name is Jorg Menger. I serve as an international tax partner of the German tax and accounting firm Ernst & Young GmbH, currently assigned to the New York office of Ernst & Young LLP, the US member firm of Ernst & Young Global Ltd. I appear before you today on my own behalf and not on behalf of Ernst & Young or any client of Ernst & Young.

The purpose of this statement is to provide a brief overview of the German corporate tax system, in particular concerning the tax treatment of foreign income earned by German corporations. The outline will also cover the historic roots of the current system. In the interest of presenting a concise statement, I will refrain, to the extent possible, from tax technical and academic citations.

A comprehensive German corporate tax code was enacted for the first time in 1920 and was subjected in the successive decades to multiple reforms. The current German corporate tax system became effective in 2001 and is based on a "classical" system of taxation at the corporate and shareholder levels. The introduction of the 2001 system was in particular driven by the need to integrate the German corporate tax system within the framework of case law issued by the European Court of Justice, which generally prohibits the member states of the European Union from discriminating for tax purposes between domestic companies and companies resident in another member state of the European Union.

In my remarks here, I will focus on the following major components of German tax policy:

- The current treatment of a corporation's earnings at the level of the corporation and its shareholders;
- The current and historical treatment of dividend income received by a German corporation from its German and foreign subsidiaries;
- The current and historical treatment of capital gains from the disposition of shares in a German or foreign corporation (share capital gains) realized by a German corporation;
- The treatment of other foreign source income, such as branch income and royalty income;
- The tax deductibility of business expenses connected to the generation of foreign source income;

- The German controlled foreign company rules, which govern the immediate imposition of German tax on certain income generated by a controlled foreign company;
- The German framework governing the exchange of goods and services between related group companies ("transfer pricing").

German tax policymakers have long focused on the successful implementation of a system of foreign source taxation that is governed by the principle of capital import neutrality, also defined as "competitive neutrality." This policy culminated in the 2001 corporate income tax reform, which introduced a broad exemption system on all dividends and share capital gains earned by German corporations, regardless of whether from domestic or foreign sources.

Taxation of German Corporations

Under the current German corporate tax code, German corporations are subject to corporate income tax on worldwide earnings, taxed at a rate of 15.825%. In addition, German corporations are subject to a second business income tax, known as "trade tax." Trade tax is levied on taxable income as determined for corporate income tax purposes, subject to a few adjustments. The trade tax rate is set by the German municipalities in which the corporation's business is carried out, and varies between 7% and 17%. The average German trade tax rate is 14%, so that the total average German income tax rate for a corporation is typically slightly below 30%.

Current System for Taxation of Dividends and Share Gains

To avoid double taxation on corporate earnings distributed within a chain of corporations, the German corporate tax code employs an exemption system for dividends distributed by a corporation to another corporation. Generally, 95% of any dividends received by a corporation are exempt from tax, and thus only 5% of the dividend income is included in taxable income. The tax policy rationale for the 5% income inclusion is to act as a compensating offset for the deduction of business expenses that are directly related to the exempt dividend income. Thus, the German tax code allows the deduction of any business expenses even if they could be related to the ownership of the shares of the distributing company, such as stewardship expenses and financing costs attributable to the shares. As described below, the rules in this regard were different before the 2001 corporate tax reform and generally disallowed deductions for expenses that could be directly traced to exempt dividend income. The implementation of the 5% inclusion rule, which is backed by the European Union's Dividend Directive, ended a constant conflict between German taxpayers and the German tax authorities concerning the circumstances under which taxpayer expenses directly associated with dividend income could be disallowed under prior law. This development represents a simplification of the overall German framework for the taxation of foreign source income.

The 95% exemption applies also to capital gains realized by a corporation through the sale of shares in another corporation. The 95% exemption applies to dividends or capital gains realized from any share in a corporation, regardless of the size of the interest held in the distributing corporation. The exemption also applies without regard to the holding period for the shares in the distributing company.

Finally, any capital losses from the disposition of shares in a corporation, or upon a liquidation of a corporation, are not deductible.

As a final note, the dividend and share capital gain exemption generally does not apply to portfolio investment income realized by life and health care insurers, and to portfolio short term trading income realized by financial institutions. In these situations, dividend income and share capital gains are fully taxable, and capital losses are fully deductible. This exception was included in the German corporate tax code in 2003 and was originally initiated by policy requests from the relevant industry which had suffered from heavy portfolio losses caused by the stock market's decline following the burst of the internet bubble at the beginning of the new millennium. The exception does not apply with respect to income from 10% or greater interests in companies based in the European Union or in most tax treaty jurisdictions (and the 95% exemption applies to such income).

The 95% exemption also is relevant for purposes of the trade tax, which is the second German business income tax. In the case of dividends, the exemption applies for trade tax purposes only for corporate taxpayers that own a significant interest in the distributing corporation, and eligibility for the exemption is subject to additional requirements if the distributing entity is outside the European Union. Generally, the trade tax code grants the 95% dividend exemption only to shareholders that have owned an interest in the distributing corporation of at least 15% since January 1 of the year in which the distribution occurs. If the distributing corporation is resident outside the European Union, the exemption applies only if the shareholder renders proof that the income of the foreign distributing corporation is exclusively generated by what is known as "active trade or business" operations (this concept is discussed in more detail below). Moreover, exemption from trade tax on dividends can be granted under tax treaty exemption provisions (which will be discussed more fully below). In the case of share capital gains, the trade tax code is fully synchronized with the corporate tax code and a 95% exemption applies to such gain.

Historical System for Taxation of Dividends and Share Gains

The current exemption system applies to both domestic and foreign source dividends and share gains. Historically, however, the German tax system had an exemption system only for foreign dividends and share capital gains, which was in place many years before 2001. The current system is a product of the earlier exemption systems.

The 1920 and 1925 corporate income tax code included a version of an exemption for dividend income. In the 1950s, Germany started the development of a modern tax treaty network that was governed by OECD principles. The first modern tax treaty of this era was concluded in 1954 with the United States, and included an exemption from German corporate income and trade tax for dividends received by a German corporate shareholder from a distributing US corporation. This 100% exemption was combined with rules that disallowed deductions for certain expenses directly related to the ownership of the shares determined using a tracing approach. This dividend exemption rule was, with some variations, included in all subsequently ratified German tax treaties. Because the exemption was provided by treaty, the conditions varied somewhat from treaty to treaty and some treaties included an

active trade or business requirement. The German corporate income tax code included rules that unified the required ownership percentages for the treaty-based dividend exemption providing for exemption on a unilateral basis for dividends from an investment of at least 10% in the distributing foreign corporation. More recently, the German corporate income tax also included provisions that extended the dividend exemption to capital gains.

Parallel to this, as a solution for dividends from foreign companies not resident in treaty jurisdictions, Germany introduced in 1972 an indirect foreign tax credit provision into the corporate income tax code. Similar to current US provisions, the indirect foreign tax credit rules allowed the tax paid by a foreign corporation to be credited against the German corporate income tax levied upon the dividend distribution. The indirect credit applied only in non-treaty cases.

To summarize the historical and current German tax treatment of dividends and capital gains: Beginning in the 1950s and in the context of the development of an extensive tax treaty network, dividends distributed by foreign companies to German corporations were exempt from German taxation subject to satisfaction of the qualifying conditions specified in the particular treaty. This treaty-based exemption was supplemented in 1972 with an indirect foreign tax credit for distributions made by non treaty based companies. The treaty-based exemption also was extended to capital gains realized on the disposition of shares. Since 2001, these rules have been replaced with a 95% exemption for dividends and capital gains received with respect to shares in both foreign and domestic corporations. Some exceptions apply to this exemption, most notably the imposition of trade tax on portfolio dividends (which are paid on a shareholding of less than 15%).

Taxation of Foreign Branches

Income generated by foreign branches of a German company is generally exempt from German taxation, if the branch is located in a treaty jurisdiction. For branches located in a non-treaty jurisdiction, the German corporate income tax code provides for a foreign tax credit. Foreign branch income is not subject to trade tax. Income from foreign real estate is also exempted under most German tax treaties; only a few German treaties revert to the foreign tax credit method on income from real estate. Many German tax treaties, including the US / German treaty, require that the relevant foreign income be taxed in the other treaty state in order to be eligible for the exemption, and this requirement has been incorporated into the German income tax code.

Expenses which were incurred by the taxpayer to generate foreign exempt branch or real estate income and which can be economically traced to a foreign investment (such as interest paid on acquisition financing) cannot be deducted. Otherwise, business expenses generally are deductible.

Taxation of Other Foreign Income

Any other foreign source income, such as royalty or interest income, is taxable, and a credit for foreign taxes, if any, generally is allowed against the German tax.

Taxation of Controlled Foreign Companies

The Foreign Tax Act was enacted in 1972 and goes back in its origins to the U.S. controlled foreign corporation rules, which were introduced in the 1960s in the United States. In principle, German Foreign Tax Act provisions subject undistributed income of a controlled foreign company to German corporate income and trade tax, generally if such income is of a passive nature and is not subject to income tax in the foreign country at an effective rate of at least 25%. However, in the case of a controlled foreign company that is resident in an EU country, these rules apply only as an anti-abuse measure in more narrowly defined circumstances.

For purposes of the Foreign Tax Act, a controlled foreign company is any company that is directly or indirectly owned or controlled more than 50% by German residents. If the foreign company receives income from capital investment (interest, income from derivatives and other financial instruments other than dividend income), the more than 50% ownership threshold is reduced to 1%. Passive income is defined in the negative, and comprises any income which is not perceived as income derived from substantial and true commercial operations or so-called "active" or "good" income. Good, active income is described in ten sub-categories:

- Farming income;
- Manufacturing, mining and oil and gas activities, generation of energy;
- Insurance or banking income of a "commercially established" insurer or financial institution;
- Trading income, except for certain trading activities between related parties;
- Service income, unless services are provided with the substantial assistance of a German resident;
- Income from real estate and other property lease income, provided that the real estate income would be exempted under a treaty had it been directly allocated to a German taxpayer. Other property lease income is good income, if generated without the substantial assistance of German resident shareholders and the foreign lessor operates as a fully commercially equipped enterprise. This category also includes royalty income, if derived from the exploitation of intangibles that were self-developed by the controlled foreign company;
- Income from financing companies which source investment capital from unrelated parties;
- Dividend income;
- Share capital gain, unless the underlying appreciation is based on income from capital investment;
- Certain foreign reorganization gains.

Most investment income (except dividends) constitutes passive income and, if low taxed, is subject to full corporate and trade tax at the level of the German parent. However, low-taxed passive income of a subsidiary that is resident in a European Union member state is only subject to German tax under these provisions if it is generated within an abusive scheme. This generally would not be the case if the subsidiary carries on its own genuine business activities; that is, if the subsidiary interacts with its own personnel and follows its own business agenda to a not immaterial extent in outside commercial

markets. Foreign Tax Act rules apply also to branch income of a German taxpayer, which is exempt under a treaty, and provide for immediate income inclusion, if the same income would have been taxed under these rules had it been generated by a controlled foreign company.

Transfer Pricing

Germany secures the correct taxation of domestic earnings within a group of related companies through an elaborate network of transfer pricing provisions, transfer pricing regulations and transfer pricing documentation obligations, all developed under the guidelines of OECD principles.

In summary, Germany has successfully implemented a system of taxation of foreign earnings, which is driven by two principles: competitive neutrality and simplicity. From a tax policy perspective, Germany started to follow a strict competitive neutrality approach with respect to foreign source earnings as early as 1950 in the context of a very high-tax German domestic environment. It was in the early 1990s that the overall tax burden on undistributed corporate earnings began to decline in the course of a series of reforms, from an effective rate of up to approximately 65% to today's 30% rate.

Thank you for giving me the opportunity to share this information on the German tax system. I would be happy to answer any questions from Members of the Committee.

Chairman CAMP. Thank you.

Mr. Avi-Yonah, you have 5 minutes, as well. And your full statement will be part of the record.

**STATEMENT OF REUVEN S. AVI-YONAH, IRWIN I. COHN
PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL**

Mr. AVI-YONAH. Thank you, Chairman Camp and Ranking Member Levin, Members of the Committee, for inviting me to testify before you on this important topic. I will make five points.

The first one is that, despite what you may have heard, the issue before us is not really about territoriality versus worldwide taxation, because, as the witnesses before me have clarified, in fact all of us have a mixed system in which we tax some income of our resident corporations overseas currently under the CFC rules or other anti-abuse provisions and other income is not. This is really not about what addresses territorial at all; this is about whether we will tax dividends that are sent back from CFCs from income that is not subject to SubPart F when it arrives to our shores. And that is the various participation exemptions that have been described.

Now, that particular narrow issue, in my opinion, has nothing to do with competitiveness. Competitiveness, as Mr. Edge, for example, has mentioned, is determined, to the extent that it is determined by taxes at all—and there are other more important topics—but to the extent it is determined by taxes, it is determined by the overall effective tax rate that is borne by a multinational from a particular country or, you could say, maybe sometimes by the effective tax rate on foreign-source income on a particular project. It is not determined by the question of whether you tax dividends when they are sent back, because that tax basically is never paid. The dividends are not repatriated if there is an additional tax that is paid on them, so how can that affect competitiveness? The issue of competitiveness has to do with the overall tax rate, not with the tax on dividends.

The second point is the recent issue with sending dividends back, and that is the issue of the trapped earning phenomenon. American multinationals don't repatriate unless there is a foreign tax credit, and a lot of their earnings overseas are subject to a low tax rate, so then they don't repatriate. But that particular issue, which is a real issue, has another much simpler solution which I think alleviates the need to deal with a lot of the other problems that I will talk about, and that solution is that we should tax those income currently as they are earned.

Now, I think that that is only feasible if we significantly reduce our rate to prevent us from being anticompetitive. But, nevertheless, I think that that would, for example, enable us not to have to worry about transfer pricing, it will enable us not to have to worry about the endless characterization of SubPart F, et cetera. So if trapped income is the real problem, then I think that is another solution.

Now, adopting an exemption for dividends without doing anything about the potential for profit shifting is really problematic. Currently, the main disincentive for American multinationals to put their profits overseas is because they know that they will not be able to bring them back without paying tax. That is the trapped income phenomenon. If we abolish that—that is, if we stop taxing dividends—then there will be no disincentive to further shift profits overseas.

And here, I think, if you listen carefully, you could see that, in fact, the anti-abuse and CFC rules of our trading partners, not just those that are represented at the table but other ones as well, are significantly different from our SubPart F, because they all take into account explicitly the effective tax rate in the source jurisdic-

tion—that is, where income is earned. And if the income is passive and is subject to low taxation at source, then that triggers SubPart F. That is the CFC rules.

Of course, our SubPart F doesn't work that way, as you all know. It has nothing to do with the effective tax rate in the source jurisdiction in almost all cases. And it enables freely to shift income from one CFC to another without triggering SubPart F so that if income, for example, is shifted to one of those four countries which has a real corporate income tax rate, our SubPart F then enables you to shift the income again to a third country which has no income tax whatsoever and leave it there as, quote, "active income" without—or as nonexistent income if you are going to disregard transfers from one CFC to another—without triggering SubPart F inclusions. And that, I think, is what makes our system particularly porous and subject to income shift abuse, and that is why we should be really careful about this.

Now, the fourth point is that this is a revenue loser. It is a revenue loser under some circumstances, specifically if we don't adopt any limitation on expense deductibility. But that seems to be the direction in which we are going, in which case it is a revenue loser and we can't afford it.

And then, finally, I think the comparison that is being done today ignores, as Ranking Member Levin mentioned in his opening remarks, other differences between our system and the overall economy of the countries that we are being compared to that I think are also relevant, and I will be happy to answer questions about them.

Thank you very much.

[The statement of Mr. Avi-Yonah follows:]

**TESTIMONY OF PROF. REUVEN S. AVI-YONAH
HEARING ON HOW OTHER COUNTRIES HAVE USED TAX REFORM
TO HELP THEIR COMPANIES COMPETE IN THE GLOBAL MARKET**

U.S. House Committee on Ways and Means

May 24, 2011

Chairman Camp, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Reuven Avi-Yonah and I am the Irwin I. Cohn Professor of Law and the Director of the International Tax Master of Law program at the University of Michigan Law School. I hold a JD (magna cum laude) from Harvard Law School and a PhD in History from Harvard University. I have over twenty years of full and part time experience in the tax area, and have been associated with or consultant to leading law firms like Wachtell, Lipton, Rosen & Katz and Cravath, Swaine & Moore. I have also served as consultant to the US Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair of the ABA Tax Section Committee on Tax Policy and Simplification, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published thirteen books and over 90 articles on various aspects of US domestic and international taxation, and have seventeen years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

In this testimony, I would like to address five points:

1. Adopting a territorial tax system is not relevant to the competitiveness of U.S.-based multinationals. Instead, what will help is plugging the holes that allow companies to shift income to tax havens, and that give other countries a competitive advantage over the United States in attracting investment capital from this country.
2. Adopting territoriality would be helpful in addressing the "trapped earnings" phenomenon, but this problem can be addressed in other and less disruptive ways.
3. Adopting territoriality without plugging the holes now in the international tax system carries serious risks of exacerbating income shifting, which is more of an issue for the US than for our trading partners.
4. Adopting territoriality without limiting the deductibility of expenses related to foreign source income will result in revenue losses we can ill afford.
5. Looking to other countries to support a case for territoriality is misplaced because it ignores key differences between the US and those countries.

1. Territoriality and Competitiveness

The leading proposals to reform the US international tax regime envisage permanently exempting dividends from foreign subsidiaries of US-based multinationals from the income of their US parents. This is a limited version of territoriality because Subpart F would still apply to passive income of those Controlled Foreign Corporations (CFCs).

This type of limited territoriality has recently been adopted by the United Kingdom and Japan, so the US is one of the few members of the OECD to continue to tax its multinationals on world-wide income. Thus, it is argued that the US should follow suit to maintain the competitiveness of its multinationals and to prevent US-based multinationals from moving to other countries.

However, the territoriality issue is not relevant to competitiveness. To the extent that taxes influence competitiveness (which is primarily determined by other factors), the competitiveness of US-based MNEs is determined by the overall effective tax rate they face compared to the overall effective tax rate faced by multinationals based in our major trading partners.¹ **There is no good data indicating that the effective tax rate faced by US-based MNEs is significantly higher than that faced by MNEs based in other OECD countries.** Moreover, as discussed below, there is reason to believe that the effective tax rate faced by US-based MNEs on foreign source income is **lower** than that faced by MNEs based in our trading partners.

Territoriality is about whether US-based MNEs will pay taxes on dividends distributed by their CFCs. Since US-based MNEs typically do not receive such dividends unless the US tax is covered by foreign tax credits, this tax has no impact on their competitiveness because they do not pay it. There is no reason to believe that US-based MNEs face any limitations in transferring funds either among their CFCs (since such transfers are now exempt from Subpart F), or on their ability to raise capital in the US. Most US MNEs are presently accumulating large amounts of cash, and they can easily access the capital markets for more, at very low interest rates. The territoriality debate has no impact on these funding decisions.

¹ While the statutory tax rate is important for income shifting, the actual burden borne by US-based and foreign based MNEs is the one relevant to competitiveness, since that is the rate that determines what the actual after tax profit of any given project will be. MNEs need to know this rate both for internal purposes and for financial reporting. I would, however, support reducing the US statutory rate if it can be done in a revenue neutral fashion (like our trading partners did when they reduced the rate but expanded the base of their corporate income taxes).

Nor is territoriality needed to keep US-based MNEs from migrating to other jurisdictions. This may have been an issue for the United Kingdom because of the relative ease of corporate migration within the EU, but when US MNEs attempted to migrate through inversion transactions, they never migrated to our major trading partners. Our migrations were always purely nominal ones to Bermuda, and those were effectively stopped in 2004. The threat of corporate migrations is a bogus one, because if it were so easy for MNEs to migrate, no OECD country could have collected significant revenues from the corporate income tax. The most convincing answer to the argument that corporate taxes must be cut because of corporate mobility is the stability of revenue from the corporate tax in OECD member countries, which indicates that while their statutory corporate rates were indeed reduced, the effective rates (which determine competitiveness) have stayed roughly the same in the era of globalization.

2. Territoriality and Trapped Earnings

If competitiveness is not a reason to adopt territoriality, is there another reason? The answer is a qualified yes: Territoriality (i.e., exempting dividends from CFCs) can address the trapped income problem. US-based MNEs have a significant amount of foreign source income (as much as \$1 trillion, based on financial statements) that they do not repatriate because it is earned in low-tax jurisdictions and will therefore trigger a US tax without foreign tax credit under current rules.

This issue was presumably one of the reasons that led the UK and Japan to adopt territoriality. Their economies are in worse shape than the US, and they needed the repatriations more than we do, given the amounts of idle cash in the coffers of the parents of US-based MNEs.

Nevertheless, there are good reasons to believe that the trapped income problem is real. First, it is clear that US-based MNEs are leaving a lot of income permanently reinvested overseas. Second, when a temporary amnesty from the dividend tax was declared in 2004, over \$300 billion in such earnings were in fact repatriated. Third, the IRS has been combating various schemes ("Killer Bs", "Deadly Ds" etc.) that were designed to repatriate foreign earnings while avoiding the dividend tax. These facts suggest that the tax on foreign source dividends impacts behavior while collecting little revenue.

However, this does not mean we have to adopt territoriality, especially given the profit shifting issues discussed below. The trapped earnings problem would also be solved if we repealed deferral, since then the foreign earnings would be subject to current US tax and there would be no tax on repatriations. We could do this without affecting competitiveness if we also reduced the corporate tax rate, as suggested by Senators Wyden and Coats in their tax reform proposal. Moreover, if we repealed deferral, our major trading partners may follow us, just like they followed us in

adopting CFC legislation. The result would be a much better world, in which all major MNEs are subject to a single low tax on their worldwide earnings, without incentives to shift income to tax havens. The spread of CFC legislation (over 30 countries and counting) shows that there can be a race to the top in international tax, not just a race to the bottom.

3. Territoriality and Profit Shifting

In choosing between the two potential solutions to the trapped income problem (territoriality and ending deferral with a lower rate), the key consideration has to be protecting the US domestic corporate tax base. The main problem with territoriality is that it will significantly increase the incentives to shift income to low-tax jurisdictions. Currently, US-based MNEs know that such income shifting will result in more trapped income, and so they leave some income in the US. If there is no tax on dividends and foreign source income is exempt, the pressure on transfer pricing and the source rules will increase exponentially.

But what about our trading partners? The key point here is that our major trading partners in fact tax foreign source income more than we do, because their CFC rules are stricter. The typical CFC rules in the OECD, including the UK and Japan as well as the large continental European countries, take into account the effective tax rate in the source jurisdiction while determining whether the parent must include the income on a current basis. Thus, in our major trading partners, if (a) the source country has a low effective rate and (b) the CFC has no real business activities in that source country, the result is current taxation.²

Our Subpart F, especially with the recent (post 1994) additions, is much more porous. It does not take the effective foreign tax rate into account (except to exclude "high taxed" income, which almost never happens) and it counts as "active" financial income and royalty income that can easily be earned in tax havens. Moreover, Subpart F (IRC 954(c)(6)) actively encourages the artificial shifting of income from high to low tax jurisdictions. As a result, despite our "world-wide" system and our trading partners' "territorial" system, **our major trading partners tax the foreign source income of their MNEs more than we do.** That is the reason they could adopt territoriality without fearing too much income shifting, and also the reason US MNEs will never migrate to any of our major trading partners.

If we adopt territoriality without reforming Subpart F, the source rules (e.g., the passage of title rule) and transfer pricing, the result will be a significant erosion of the US domestic corporate tax base. Deferral is already our biggest corporate tax expenditure (\$73 billion). We cannot afford to expand it further by converting it to

² For a description of these CFC rules see Joint Committee on Taxation, Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income, JCX-33-11 (May 20, 2011).

exemption, and the best course would be to get rid of it altogether in the context of an overall corporate tax reform.

4. Territoriality and Expense Deductibility

It has, however, been argued that adopting territoriality would raise revenue, rather than lose it.³ This argument, however, crucially assumes that we will in fact disallow all expenses allocated to the newly exempt foreign source income.

In pure tax policy terms, expenses allocated to exempt income should not be deductible, because the result is tax arbitrage and negative effective tax rates. That is what we do domestically. But even the Obama Administration has backed away from restricting the deductibility of R&D that gives rise to foreign source income, lest they drive such R&D to other countries (a more realistic fear than corporate migrations, since US-based MNEs do in fact conduct R&D in tax free zones in various non-OECD countries). And it seems unlikely that Congress will enact significant restrictions even on interest deductibility, which has been proposed by the Administration repeatedly with no results. In the absence of such restrictions, territoriality becomes a revenue loser, which we can ill afford given the budget deficit.

5. The Context of Tax Reform

But, it will be said, how could our trading partners afford to enact territoriality, given that they also face large budget deficits? The answer is that their tax policy context is quite different, and that it is a crucial mistake to focus solely on the territoriality issue without taking that broader context into account.

What are some crucial differences between the US and our trading partners? First, they are smaller economies, and therefore depend more on foreign trade than we do. This also makes it more likely that their MNEs will migrate (e.g., from the UK to Ireland) since they do not have a huge domestic market to serve (and many MNEs need to be close to their main market). Second, their economies are typically in

³ For various proposals with different revenue estimates depending on the assumptions regarding expense deductibility see National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (December 2010), pp. 28-35; The President's Economic Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, pp. 89-91; U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007; President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November 2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 186-97.

worse shape, so that they need repatriations more. Third, and most crucially, they all have higher personal income tax rates, as well as a VAT.

This brings us all the way back to where we started- the question of competitiveness. It is a mistake to compare the competitiveness of US and foreign-based MNEs by focusing solely on the effective corporate tax rate. Not less relevant are the personal income tax rates borne by their managers and employees, as well as the VATs borne by their employees and customers. If these non-corporate taxes are taken into account, the effective tax rate on US-based MNEs, as well as purely domestic US businesses (incorporated or otherwise) is significantly lower than that on MNEs based in our major trading partners.

These non-corporate taxes also explain why our trading partners could afford to adopt territoriality. Not only did they need repatriations more and could combat profit shifting more effectively, they could also easily make up for any lost revenue by raising the personal income tax rates and the VAT rates, as the UK did when it adopted territoriality. In the US, raising individual income tax rates to European levels is off the table, and we do not have a VAT. Thus, we cannot afford to follow in the lead of Japan and the UK, even if it were otherwise advisable to do so.

6. Conclusion

To conclude, let me restate the main arguments made above:

- a. Adopting territoriality is irrelevant to the competitiveness of US-based MNEs.
- b. Adopting territoriality could help eliminate the trapped income problem, but so could abolishing deferral, which we could do if we lowered the corporate rate.
- c. Adopting territoriality would increase incentives to shift income out of the US.
- d. Adopting territoriality without limiting the deductibility of expenses allocated to exempt dividends would lead to revenue losses
- e. Following the lead of other countries who adopted territoriality without considering their different economic and tax policy circumstances is a mistake.

Chairman CAMP. Well, thank you. Thank you very much.

I would just like to point out, a territorial system or international tax system does not need to lose revenue. I mean, it could be designed in such a way that it is revenue-neutral. And that would be another sort of discussion.

But I did have a question, particularly for Mr. Thomas and I think anyone who wanted to weigh in, all four of you who are really talking about particular countries.

What were some of the underlying reasons we have seen some dramatic changes in international tax law and tax reform? Was it about competing abroad? Was it making their workers more competitive? What were some of the underlying reasons?

And if you want to start, Mr. Thomas, we can just go down the row.

Mr. THOMAS. Thank you.

I like to use a sports analogy, an American football team on the field playing against a U.K. soccer team. The American football team goes on the field. There are all sorts of complex rules and penalties. They have to huddle, they have to determine how they could move the ball forward within all those complex rules. At the same time, the soccer team is out running around the entire field reacting on a second-by-second basis to what is happening everywhere and simply can be much more flexible.

My sense is that Japan looked around, They did do benchmarking. They looked at other countries, and they came to the conclusion that the rest of the world is playing soccer and that Japan should play soccer, as well, in order to compete effectively in each of the jurisdictions in which they are competing with companies from France, Germany, and the U.K., and particularly throughout Asia where there are many emerging countries growing rapidly, with many of those countries offering various tax incentives for business that the Japanese companies want to take advantage of.

Chairman CAMP. All right.

Mr. SCHOON. In the Netherlands, it is not a recent development but it has been reviewed over time. And I quoted the statement by the state secretary of the ministry for finance in the 1990s. The idea is, indeed, capital import neutrality, to be able to compete locally, and also to recognize the sovereignty of third countries.

Chairman CAMP. Thank you.

Mr. Edge.

Mr. EDGE. For me, in the U.K., competitiveness is at the heart of it. When I talk to my U.K.-based multinational clients, they can achieve low effective tax rates but only, as someone said to me, by running working very hard. And if they look at their peer groups around the rest of Europe and in the U.S., they will find that effective tax rates at a global level are lower. And that does make it very difficult for you to compete, particularly if you are looking to acquire other companies and grow.

And as a symptom of that, in 2007, when the last Labour government was looking to extend the CFC rules, that was seen as having a direct effect on effective tax rates. And it resulted not in a mass exodus, only a number of small companies left, but the bigger companies in the U.K.—and a number of them said this publicly—said, we like the U.K. for everything else it has to offer; if the tax system is going to make it uncompetitive, we have to work with government and change it. So it is competitiveness that has driven the change.

Chairman CAMP. All right.

Mr. Menger.

Mr. MENGER. Yes, Germany didn't change the system. They have an exemption system since after World War II. And the German system is driven by the capital import neutrality in order to compete in the foreign markets.

Chairman CAMP. All right. Thank you.

And, Mr. Thomas, to what extent, as you talked about these rules, football versus soccer, to what extent did corporate tax rates play in the decision to make changes in Japan, as well as the dou-

ble taxation of foreign-source profits? What were the factors that really sort of drove that, or the rules, as you called them?

Mr. THOMAS. Well, I think there were quite a number of factors. The Japan authorities were concerned about the complexity of the tax system, and the resources that Japanese companies were having to devote toward complying with the tax laws. In fact, I hold here in one hand the entire Japanese national and local corporate tax laws, income tax laws, and all the other tax laws and regulations. They prefer simplicity. They prefer not having to maintain armies of tax lawyers to figure out what the laws mean and to comply with them.

I think that they definitely wanted to be able to take advantage of the various types of tax incentives that are granted in other countries, particularly in Asia. And they felt they could do this effectively really only by adopting a territorial system.

Chairman CAMP. Mr. Schoon, the Netherlands has had—I know you call it a worldwide system, but it is, in effect, a territorial system, or at least how we look at it. So I just wanted to make sure we are using the same terminology. And you have had it for a hundred years.

What are some of the structural issues that continues to maintain that sort of tax policy that you look at? What are some of the reasons that that has worked for the Netherlands, I guess is a better way to put it.

Mr. SCHOON. You know, the reasons that it has worked, I think, as I referred to earlier, it did allow Dutch companies to grow, Dutch multinationals to grow in a way that, you know, was acceptable and preferred by the Dutch Government. So I think that that is the most important aspect, actually, the stimulation that that created.

Chairman CAMP. All right.

And, Mr. Edge, I think you mentioned that corporate rates did play a significant role in the U.K. Were there other factors, as well?

Mr. EDGE. EU pressures, which, of course, affect the other two European countries here, have come into it. But, interestingly, I think the Revenue haven't yet admitted that they have been losing the litigation on that, so they have been trying to work around it.

At the heart of the changes has been the fact that the U.K., with a maritime tradition and a mercantile tradition, has wanted to have a competitive system to attract people to the U.K. I make the point in my testimony, I don't know whether Members of the Committee will remember that, that when we put our tax rate up to 52 percent in 1972, we had to take immediate action so that U.S. companies who were investing in the U.K. did not suffer that 52 percent rate but could, through the double tax treaty that was negotiated, get a tax refund in the U.K. to bring that tax down. I think the U.S. rate then was 40 percent.

Early in my career, when U.K. tax rates were a somewhat eye-watering 83 and 98 percent for individuals and, as I say, 52 percent for corporations, I spent quite a bit of time working on Northern Ireland investments, where they looked rather jealously across the border at then the Irish incentives, Northern Ireland then got its fair share of industrial basket cases.

Interestingly, the government, in the last budget, has announced that it is proposing something rather radical, which is a lower tax rate for Northern Ireland as part of the U.K., simply so that, with its identical geographic position and economic advantages to Southern Ireland, it could compete evenly across the border. So even the low U.K. rate is thought to be uncompetitive on the island of Ireland.

Chairman CAMP. Thank you.

Mr. Levin may inquire.

Mr. LEVIN. Thank you very much.

And I think it is very useful to have this hearing and to really scratch beneath the surface and try to go beyond labels, because I think, as we read the testimony, all of these systems are mixed to some degree, and you don't have either/or.

We pulled out, for example, provisions that show the mixed nature, just to review a few of them quickly. For Japan, there are major transfer pricing guidelines. Also, there are certain provisions relating to denial/deferral on certain types of passive income, and also there are certain provisions relating to royalty income. And also, I am not sure it was mentioned, the present system subjects 5 percent of dividends to taxation. That is a system used in other countries.

In terms of the Netherlands, as we extracted the provisions there that I think show the mixed nature, some of them are fairly complicated. Under, for example, the ownership test, that interest in a subsidiary cannot be held as a portfolio investment. And then you have a lot of other anti-abuse provisions and provisions relating to foreign branches. And it is interesting, on royalties, that they have a higher tax except where there is an innovation box provision, which I think again shows the mixed nature of this.

With Germany, which I guess has an older system, with 95 percent, also you have exemptions relating to dividends, also to branches that are in a non-treaty jurisdiction. So there is a differential between investments or operations by a corporation one place or another, depending where there is a tax treaty. Also, differentials as to whether income is passive or not. And, also, some major transfer pricing provisions that reflect the OECD guidelines.

And so, as you go through this, looking at the Netherlands and the U.K., you see that what we need to do is pierce through the surface and try to go beyond either/or propositions, look at what the realities are here and overseas, and to see, that the primary standard has to relate to our competitiveness.

My plea is that we all take the time, and I think your testimony is indeed useful, to look at the complexities in each of these systems, because they are just not simple. You held up the code, and I didn't ask you how many pages they are, but it is more than a few and not as many as we have here.

And I think, also, we should take seriously the testimony that was given by Mr. Avi-Yonah in terms of what is the reality within each of these territorial systems and how they relate to what we have today. And I think we will see the complexity.

Professor, you suggest the elimination of deferral. That, in itself, is very complex and controversial. And as I said a few weeks ago, when Amo Houghton and I, many years ago, sat down for a couple

days on a bipartisan basis to look at our international tax system, we came up with some ideas, some of which were incorporated in legislation. But when we got to deferral, we came to a stop, because it was difficult to find a strong basis on which to proceed.

So thank you very, very much for your testimony.

Chairman CAMP. Mr. Herger is recognized.

Mr. HERGER. Thank you, Mr. Chairman.

Critics of a territorial tax system often argue that it will result in companies shipping jobs overseas. Based on your experiences and observations, does adopting a territorial tax system result in jobs being shipped overseas?

And I would like to ask each of our witnesses that represent other countries, beginning with you, Mr. Thomas.

Mr. THOMAS. Thank you. That is certainly a very important question. As I indicated in my testimony, the Japanese Government was concerned. They consulted very closely with business. They tried to learn from business what factors are involved in deciding to set up operations overseas or move operations overseas, and they concluded that there were a variety of very legitimate business reasons for doing so.

Japan recognizes that due to population growth, or relative lack of population growth in Japan, frankly there is going to be more economic growth outside of Japan. The principal policy objective in Japan is what they call a "virtuous growth cycle." A virtuous growth cycle would involve assisting and encouraging Japanese companies to grow outside Japan and to bring the profits back into Japan for enhanced domestic investment. They view the situation as a win-win, not as a zero-sum game. And, consequently, at the end of the day, they concluded that the risk of jobs being shifted overseas was far less than the benefit of encouraging Japanese companies to expand and bring the profits back into Japan to help the Japanese economy.

Mr. HERGER. Thank you. Mr. Schoon.

Mr. SCHOON. In the Netherlands it is the same; the experience of a hundred years that I think strengthened the Dutch Government in its position that this is, for the Netherlands, the appropriate system and on a net basis does not lead to a shift in jobs overseas.

Mr. HERGER. Mr. Edge.

Mr. EDGE. The concern in the U.K., I think, has not been as I have seen it here in the U.S., that this encourages people to create jobs overseas. To the extent we had concerns, they have actually been that U.K. companies coming under the control of foreign multinationals has led to loss of jobs in the U.K. That has been quite a controversial issues in a number of areas recently.

The philosophy in the U.K., as I said earlier, is than if you try to use the tax system to force people to invest at home and make it less attractive to invest overseas, rather than letting everything be treated on a level playing field as part of a total package, then you will eventually make your own multinationals uncompetitive. And, if you do that, then you go back to the first position, which is your big companies come under the control of foreign companies and then you no longer have the national sway that you thought you had.

You are actually maintaining the influence and trying to make sure that businesses don't find tax a driving factor in where they put investments and do jobs. But tax is, as I say, just a part of the package.

Mr. HERGER. Mr. Menger.

Mr. MENGGER. The legislative history in Germany shows that the policymakers believe that capital import neutrality would generate jobs in Germany by making German companies competitive abroad under competitive tax rates, and that is generating jobs in Germany to manufacture and design all the products which are sold abroad.

Mr. HERGER. Mr. Avi-Yonah.

Mr. AVI-YONAH. I don't know of any evidence that indicates that this particular provision—that is, whether you tax or do not tax dividends paid by CFCs to the parent companies—has any effect on jobs by itself. But I think the broader question of the tax rate—the effective tax rate on foreign-source income certainly can have an effect on both income shifting and potentially job creation outside the country where the parent is in place.

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

Chairman CAMP. Thank you. Mr. Johnson.

Mr. JOHNSON. Thank you. Mr. Chairman.

You know, it sounds like to me that you all agree since the U.S. last reduced its corporate tax rate through the 1986 tax reform, that our major trading partners have moved past the U.S. in terms of reducing the corporate tax burden by lowering rates and going to a territorial system.

Is that what you all are saying? Am I reading you right? It also eliminates our need for an IRS army to go out and try to persecute these companies, I think.

Would you all agree that our current corporate tax system hurts the U.S. economy, the competitiveness and jobs worldwide? Go ahead, Mr. Thomas.

Mr. THOMAS. I believe that it does. I work for U.S. companies and French companies and German companies in Japan. Many times when we try to set up transactions or we try to reorganize operations, the French and German companies really don't have a problem under their territorial tax systems. The U.S. companies look at the particular proposal and there always seems to be a foreign tax credit problem or a CFC problem or some other problem that prevents them from doing what would be best for their business in Japan. And, again, it is not an issue that the French or German companies seem to face.

Mr. JOHNSON. Go ahead, if you have got a comment.

Mr. SCHOON. It is hard for me to judge what the impact would be from the U.S. system for the U.S. multinationals. But I would believe that if the Netherlands would abandon the territorial system, they would put their companies at a competitive disadvantage.

Mr. JOHNSON. Competitive worldwide, you mean?

Mr. SCHOON. Yes.

Mr. EDGE. During the 1980s when we were looking at a lot of possible U.S.-U.K. mergers, the U.S. and UK advisers used to compete which had the most horrible system, We used to wonder as to

whether we could find somewhere else that was more friendly. We looked then to our friends in the Netherlands. Of course at the end of the day, you came back to all the other parts of the package and you ended up being in the U.S. or the U.K. because of all the other bits and pieces there. But from my perception I would say that the U.K. has gone in the right direction of lower tax rates in a territorial system, and it seems to me that the U.S. would benefit from that.

It would be interesting to see what the position would be here if your capital markets weren't so strong and you didn't have anti-inversion rules. That certainly influenced the U.K. Government thinking a lot.

Mr. MENGER. There are a lot of factors influencing the U.S. system and it is very difficult for me to judge what is best for the United States. But I can mention that in Germany there were discussions; German legislators were looking at the U.S. system once or twice, and then decided it is too complicated for Germany and therefore Germany

Mr. JOHNSON. I think it is too complicated for us, too. That is a good statement.

Mr. Avi-Yonah, do you have any comment?

Mr. AVI-YONAH. I have to say I do not see our companies suffering so much. American companies recently have been doing extremely well worldwide and the basic reason, as far as tax is concerned—I think it basically is for other reasons, but as far as tax is concerned, is that we don't tax our overseas profits more than any other of the countries that are represented here.

Mr. JOHNSON. Yeah, but we are leaving money overseas because they are afraid to bring it back and get it taxed at a high rate. Under our current deferral system, but not under a territorial system, foreign earnings are subject to U.S. tax when they are repatriated to the United States. You know that.

What I would like to know from you all is, what did the U.K. and Japan do about accumulated foreign earnings when they transitioned to a territorial system? I am about to run out of time, so be quick, please.

Mr. THOMAS. Japan imposed no restrictions. Basically, any dividends that were paid from foreign subsidiaries during a taxable year beginning on or after April 1, 2009 are subject to the exemption.

Mr. JOHNSON. Do you all agree with that? Mr. Edge.

Mr. EDGE. In the U.K. we did not distinguish. That would have been seen to have been an unfair distortion. But most importantly, the point was made quite forcibly to the government that if they did try to distinguish, the profits would end up in Ireland and not in the U.K. because companies would leave.

Mr. JOHNSON. Thank you very much. I appreciate your testimony.

Chairman CAMP. Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want to thank you all for coming here. I have a feeling as though I have seen this movie before, because the Japanese have a health care system and the Dutch have a health care system and the English have a health care system and the Germans have a health care system and they

are all different. And never have we had a hearing in the Congress where we asked them to come in and talk about how they run a health care system that is half as expensive as our own. So it seems strange that we are asking you to come in here and talk about systems developed in your own countries.

And Dr. Avi-Yonah, I would like to ask, you nailed it down to one issue as to why we are here. We are not going to do what the Germans do, we are not going to do what the English do, we will not do what the Dutch do, we will not do what the Japanese do, because we are Americans. And we have developed this system—complicated, yes.

Why are we having this hearing? It sounded to me like you were saying it is money left overseas, and we have two ways to get rid of the problem. One is tax it while it is over there, just get rid of deferral. And then—explain to me why are we talking about competitiveness. Because in health care we never look at the Europeans to see what is the best way to do it. They don't know anything. We only know. That is how our health care system was developed. The same with our tax structure. So tell me, what it is that we are really here discussing today?

Mr. AVI-YONAH. What we are discussing is this very narrow question, it seems to me, which is what to do about dividends that are distributed upstream at CFCs not held as income. That is the issue on the table. And the other countries, some recently some before, have decided not to tax them. It has nothing to do with the competitiveness. American multinationals don't have any problem shifting profits around even from their overseas operations, one to another, or raising money at home or borrowing at very low rates, or even when their stock price reflects overseas income, it does nothing in any of this issue of trapped earnings overseas that affects their competitiveness. They are perfectly fine and competitive with the current system.

The issue is some people argue that leaving the money overseas means that they don't invest it at home. You know, you can argue about what the economic effects of that would or would not be. We had a 1-year experiment in 2004–2005 and the economic effects are not so stellar. But they did make enough money—

Mr. MCDERMOTT. You mean the one—

Mr. AVI-YONAH. When we allowed the creation—

Mr. MCDERMOTT. And they handed it out in dividends rather than investing it in any kind of—

Mr. AVI-YONAH. Right. But I think you can argue that there is an impediment there. There is no question that they usually don't, because they have to pay an extra tax, and they also engage in all kinds of complicated transactions to try to repatriate without paying the tax. So that puts a burden on the IRS to try to fight these transactions.

So I would say that something should be done about that. But in my opinion, if we were to reduce the rate to something like the OECD average, we could abolish deferral and then we could get rid of a lot of this complexity that is currently in the code and we would not have a competitive disadvantage because of that either. And then the money can simply flow freely within the multinationals without having any tax effect.

Mr. MCDERMOTT. Which way would you go? You have these two ways to go. Which way would you recommend to us to go?

Mr. AVI-YONAH. I would not recommend going territorial, because I think that this strongly increases the incentive to shift profits overseas. We know that American multinationals already use a lot of transfer pricing and other transactions in order to increase their overseas profits. And we have recently heard about large American multinationals putting their money overseas and paying very, very low effective tax rates on that money. And we have also had a hearing just last summer in this committee discussing all the ways in which they shift profits.

But I think the one disincentive that currently exists is this problem, if they put more money overseas they will not be able to bring it back without paying taxes. And I think that if we eliminate that—

Mr. MCDERMOTT. Tax it as it is made?

Mr. AVI-YONAH. Yes.

Mr. MCDERMOTT. Then they can move it anyplace they want.

Mr. AVI-YONAH. Yes, we we abolish deferral; there is no problem with transfer pricing; they can move it anyplace they want. They can bring it back here and there will not be a tax disincentive to do that.

Mr. MCDERMOTT. Why do you think they don't want that? We could pass a bill here in 15 minutes to get rid of the ability to defer taxes and keep it outside the country.

Mr. AVI-YONAH. I don't think that all of them don't want it. What I have read recently is that some have actually said if the corporate tax rate is reduced sufficiently, they would be willing to leave it inside the system. That came from GE, which was one of the companies that was highlighted recently in terms of how good their overseas tax strategy is.

Chairman CAMP. Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman, for holding this important hearing. As opposed to health care where our local doctors, for example, don't compete globally to provide services to us, our businesses do compete globally for customers. And what we have learned through this hearing and others is that America has fallen behind. Where we used to hold a distinct advantage in competitive tax rates, in fact our global competitors have taken a page from our playbook and are beating us at it. It is costing us jobs.

The goal today is to find out how we become competitive to make sure that we have the strongest economy of the 21st century, not the strongest economy until China catches us or the European Union becomes more competitive, but how do we create the strongest economy for the next 100 years.

This hearing I think is very important for exploring it. I want to follow up with Mr. Johnson's conversation and direct a question to Mr. Thomas and Mr. Edge, if I may. And by the way, all the panelists have been excellent today.

You know, as Mr. Johnson said, many critics of the current U.S. worldwide tax system argue the current system has a lockout effect which forces U.S. companies to hoard cash overseas and not distribute those earnings back to the U.S. where those earnings could be deployed for domestic investments. They are, by some estimates,

\$1 trillion in stranded U.S. profits overseas eager to be brought back here. In fact, Mr. Thomas' testimony stated the lockout effect was one of the primary reasons why Japan adopted the territorial tax system.

Mr. Thomas and Mr. Edge, based on your experiences, you believe that the lockout effect is an impediment to domestic investment?

Mr. THOMAS. Yes, I believe it is an impediment. Japan's rules have been in effect only for a short period of time but initial indications are that repatriation of profits is increasing. And frankly, given the recent disaster in Japan, more and more Japanese companies will probably need to bring profits back into Japan to help with their rebuilding. So I definitely believe that the lockout effect is a problem, and the Japanese Government recognized that and that is why they changed their system.

Mr. EDGE. The U.K. has not had as much trouble with where overseas cash gets used because, as I explained in my testimony, we did not have rules dealing with upstream loans. That meant the money could be brought back to the U.K. not only tax free- but in theory at the cost of a further detriment to the U.K. because of the additional interest deduction that that created. You then had money being lent back to the U.K. rather than being paid back to the U.K. by way of dividend.

Once you have reached the conclusion that you deal with abuse through CFC rules, and through interest allocation, through tax pricing, then the essence of the territorial system as we have adopted is that you should take tax off the table in terms of deciding where corporations should invest their money. And therefore I think that leaving cash offshore because of tax reasons is an artificiality that is very good to get rid of.

Mr. BRADY. The comment has been made that the way to address and solve the lockout problem is that you move to a territorial system or end deferral. Most of the countries that faced that decision have chosen to move to a territorial system. In your view, given a choice between ending deferral or moving to a territorial system, what is your recommendation to the panel?

Mr. THOMAS. I would definitely recommend moving to a territorial system. Moving to ending deferral would be a step backwards. Again, the rest of the world is playing soccer. I think for U.S. companies to be competitive, we need to move to a territorial system.

Mr. EDGE. I think you get much greater complexity if you get rid of deferral and you have to address the different ways in which taxable interest is calculated in different jurisdictions. And if you go for a territorial system life is much simpler; you let the total package that each country has to offer stand on its own.

Mr. BRADY. Great. Thank you. I appreciate the panel and everyone has been very insightful today.

Mr. Chairman, thank you.

Chairman CAMP. Mr. Nunes.

Mr. NUNES. Thank you, Mr. Chairman. At this time I would like to yield my 5 minutes to the chairman of the Select Revenue Subcommittee.

Mr. TIBERI. Thank you, Mr. Nunes. Thank you, Mr. Chairman, for holding this hearing today.

Kind of following up on what Mr. Brady talked about, Mr. Thomas, with respect to the lock-out effect that he talked about. We had a week and a half ago a hearing with four CFOs, and in response to a question from me one of the CFOs with respect to the lock-out effect said—this is a quote—“the Tax Code certainly is structured in a way where there are significant disincentives to bringing those earnings and profits back here to the U.S.” So if we are looking to invest in the U.S., we have to find alternative sources of capital to make those investments.

To piggyback on Mr. Brady’s question, from your experience in Japan—for what you just went through in Japan—what the Japanese just went through in Japan—can you give us some further insight as to the debate with respect to the territorial system and the lock-out effect and how that debate centered around creating more capital for the Japanese in Japan?

Mr. THOMAS. Absolutely. I think it is well known that the Japanese financial institutions are still in the process of recovering from the recent global financial crisis, and, consequently, their ability to lend to Japanese companies is far more restricted than it used to be. That was one of the issues the Japanese Government took into account. They wanted to enable Japanese companies to bring their profits back into Japan to avoid the lockout effect in order to help them continue to fund their operations and to do so in the most cost-effective manner.

The Japanese business response was they felt it was much better for them to bring the profits back as opposed to trying to borrow within Japan under these circumstances.

Mr. TIBERI. Thank you. To the four of you in the countries where you do tax work, if you could just comment on this question that I have. Some of my colleagues on the other side of the aisle seem to link going to a territorial system and adding a value-added tax. We have heard that not only today but in other hearings.

Now I have family in Italy, and from what I hear from them, and they are not tax experts, the value-added tax is really to provide for a social safety network for more of a welfare state. I certainly don’t know what it is like in the countries that you do work in.

But starting with you, Mr. Menger, in Germany, was there a link between going to a territorial system and adding a value-added tax? Can you give us some context to that?

Mr. MENGER. Yes. There was no link. Germany, after World War II, had the participation exemption, the territorial system for corporate entities, and at the same time had a kind of VAT. It was slightly different. Later it was governed by the European Union. But there is no link between the two. And also from a policy perspective, there is legislative history that you wouldn’t be able—the policymaker wouldn’t be able to change or raise the VAT rate in order to pay for a changes in the corporate tax rate. Politically they are clearly disconnected and separate issues for financing different needs of the government.

Mr. TIBERI. Mr. Edge.

Mr. EDGE. That is true in the U.K. as well. I don’t think there is any link between the VAT increases that we have had over the

years, particularly the one in the last budget which was expressed to be to help deal with the deficit problem. The last government that I can remember in the U.K. making a major switch to taxes on spending was the Thatcher government, coming in in 1979, when that was very definitely the trend at that point, and that is when U.K. corporate tax rates starting going down.

It is interesting, in one of the documents that I put in there, the 2007 consulting document, the Revenue themselves admit that the yield from foreign dividends is very low. Yes, there was a lot of cash offshore, but there were no basis under the tax system short of just grabbing it—which would have resulted in lots of people leaving—under which you could have taxed it.

So I personally don't think, although you don't know what is in the tax legislators' mind, that there was any link between the VAT increase in the recent budget and the exemption.

Mr. SCHOON. I am not aware of any link in the Netherlands. As I mentioned, the territorial system was developed over a very long time and the individual components of the Dutch tax system in general.

Mr. THOMAS. There was no link in Japan between the adoption of a territorial system and Japan's consumption tax.

Chairman CAMP. Thank you. Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

I can understand the conversation as it relates to businesses that take advantages of preferences built into the Code and those who use legal mechanisms to seek low-tax jurisdictions. Part of the conversation as we discuss the territorial system versus the worldwide system, though, needs to focus on what our European friends have done to combat avoidance. You have heard me say here on the panel many times, I believe there is a difference between avoidance and deferral. But tax evasion in no-tax jurisdictions seems to me to be an opportunity to promote some credibility as we pursue tax reform.

And Mr. Edge, how does the United Kingdom pursue tax evasion? The difference would be in this instance the Cayman Islands or Bermuda or Liechtenstein or some of those no-tax jurisdictions.

Mr. EDGE. The answer to that question is "with handcuffs". Tax evasion is criminal. If it occurs, then the tax authority will do everything they can to catch it. There has been increasing cooperation between tax authorities in developed countries and the tax havens I think that is a good thing.

There is a middle ground between aggressive tax avoidance and what you might call routine tax planning. As I say in my testimony, there was aggressive tax avoidance in the past because the rules were perceived to be too harsh.

In the CFC area I would personally be surprised if that happened in the future because there is now a much better relationship between government and the Revenue and industry, and that much more open relationship plus the territorial system and what people perceive to be a tax system that is respected must help a lot. You can't rule out human greed, but I hope we will get to a situation where business will be able to get on with business and not worry so much about, as I said early on, having to run very hard to get the effective tax rate down.

Mr. NEAL. Mr. Menger.

Mr. MENGER. With regard to Germany, Germany looked at your U.S. SubPart F rules, and Germany has CFC legislation which applies if there is passive income and low tax. And in these cases there is full taxation in Germany. So it is a system that overlays and takes care of passive income with low taxation.

Mr. NEAL. But, Mr. Chairman, I would hope that we would have an opportunity here in the committee to have a hearing on no-tax jurisdictions. I think that again lends some credibility to the task at hand. That is how to make American corporations more competitive, again distinguishing between no-tax jurisdictions and low-tax jurisdictions. At least those that have a low-tax jurisdictions have a corporate tax rate. That is a separate argument.

Mr. Avi-Yonah, Mr. Edge stated that getting rid of deferral would increase complexity, but you are saying the opposite. Moving to a territorial system would put pressure on our transfer pricing rules and SubPart F rules, possibly leading to greater complexity in the tax system. Would the two of you care to elaborate?

Mr. AVI-YONAH. Well, I think those two areas are clearly areas in which abolishing deferral would greatly simplify our tax system. SubPart F, as you know, is entirely devoted over hundreds and hundreds of pages of regulations to drawing very fine distinctions between the income that is currently taxed and income that is not currently taxed. All of that would disappear if we did not have deferral. Most of our transfer pricing enforcement and almost all of the big transfer pricing litigation that we have had in this country were outbound cases; that is, cases about American corporations shifting income overseas. There were very few inbound cases. All of that likewise disappears if you don't have deferral. In fact SubPart F was enacted in part in order to bolster transfer pricing enforcements back in the 1960s.

So other than the fact that we have a foreign tax credit—but even that is a complicated measure that we will have to retain if we abolish deferral—but I think even with territoriality, we are going to keep the foreign tax credit. Nobody suggested that we will abolish the foreign tax credit altogether. Because we still are going to tax some forms of foreign source. Nobody is suggesting abolishing SubPart F either. I think territoriality keeps all the most complicated elements of our Tax Code and greatly enhances the enforcement problem that we face.

Mr. NEAL. Mr. Edge, do you want to quickly respond to that?

Mr. EDGE. I don't see the anti-avoidance aspects on a territorial system as greatly increasing the burden of the tax authorities. If you are trying to create jobs, I suspect that a good way to create jobs is to have armies of people working out what creditable taxes are.

Chairman CAMP. Thank you. Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Mr. Chairman.

Mr. Avi-Yonah—I get my name mispronounced every day, I didn't want to mispronounce yours—you made a statement and I will paraphrase the statement—and correct me if I am wrong—that the current tax structure for the United States doesn't lead to American companies making a choice of moving jobs overseas, mov-

ing corporate headquarters overseas. I don't think you said it that way. Could you repeat that again as to our current tax structure?

Mr. AVI-YONAH. I usually try not to talk about jobs specifically, because first of all, I am not an economist. And I think the economic literature that I am familiar with is ambivalent about what precisely the effect of U.S. multinationals expanding overseas on jobs here in the United States. There are studies with which you may be familiar, and there has been testimony before this committee before, that increasing U.S. multinational operations is a complement to U.S. job creation, and there are other studies that it is a substitute; namely, that you close factories here and move them overseas. I think it probably depends on—move from national and multinational—depends on the situation.

What I can say, however, is that clearly our current system creates an incentive to shift income overseas and profits overseas in an artificial manner, and that I think there is plenty of evidence for and there have been a lot of reports both in the media and in the academic literature recently about that.

Mr. TIBERI. I am trying to engage you in your thought process and maybe I can't convince of you this. I have talked to CFOs far and wide of American multinational corporations—and we had a hearing a couple of weeks ago, as I said earlier—who are growing their American businesses overseas in emerging markets overseas in Asia and Europe. For instance, selling diapers. And when they sell diapers abroad, as an example, they are going to compete with somebody else who is selling diapers. If they don't sell diapers overseas, somebody else is going to sell those diapers overseas. And when they sell those diapers overseas they are not going to make them in Ohio, they are going to make them close to where they are being sold overseas. Some would say that is shipping jobs overseas, but if they are not going to sell diapers overseas they are not going to make diapers overseas.

And then you have the issue of returning profits. And as they continue to compete in a world marketplace where they are being taxed differently than their competitors who are headquartered in Germany, in the U.K., in the Netherlands, or in Japan, they are at a competitive disadvantage.

And we had four CEOs last week. One of them said, "my biggest concern is that we are going to be taken over by a foreign competitor."

I used to walk to grade school in Columbus, Ohio, and I could smell the hops of the brewery down the street that I thought would be an American brewery forever, Anheuser Busch. It is no longer an American brewery, in part because of the business they do and the American Tax Code. Do you just not recognize that reality in the world?

Mr. AVI-YONAH. It seems to me that the American multinational, including let's say P&G, is competing very nicely overseas. And one reason that they are doing that is they don't pay too much tax on their overseas profits. And I don't think there is any evidence that the effective tax rate that the American multinationals pay on their overseas profit is higher than that of companies headquartered in any of these other—

Mr. TIBERI. But the Tax Code that we have today makes them make a financial decision that if they bring those profits back here they are double-taxed, as opposed to a U.K. company they are competing against that does not have to have that double taxation. So it is a perverse incentive for them to keep their money overseas—unless there is a tax holiday—to keep that money overseas and invest it overseas. Does that not occur to you at all?

Mr. AVI-YONAH. No. First of all they are not double-taxed. There is no double taxation because we do have a foreign tax credit. When the dividend comes back, we only tax it if it has not been taxed overseas. We give a foreign tax credit if it has been taxed. And I don't think this particular distinction has any impact on the competitiveness of American businesses because they don't bring the money back if it is going to be taxed. The money is overseas and they have plenty of money here in the United States.

Mr. TIBERI. My wife says men are from Mars and women are from Venus. I am starting to think differently here. Mr. Edge, if you have a diaper company in the U.K. that is competing with an American company, did my example make sense to you?

Mr. EDGE. Yes, I empathize with it considerably. You saw I was nodding my head as you were speaking. I think the correct term—

Chairman CAMP. The time has expired, so if you could answer very quickly.

Mr. EDGE. Very quickly, the correct answer is there is double tax because two jurisdictions are having a bite at the cherry. You don't level down. Allow each jurisdiction to stand on its own.

Chairman CAMP. Mr. Davis is recognized for 5 minutes.

Mr. DAVIS. Thank you, Mr. Chairman.

I would like to follow a little bit on this line of discussion, maybe in a wider area. I am surprised about the commentary that American companies are doing just fine overseas. I have a question relating to this competition between tax systems, and I am intrigued that Britain and Japan have moved into this area.

The first area that I would like to touch on is the area of mergers and acquisitions. My colleague just mentioned the American brewing industry. It used to be American at one time. But as I have looked particularly in the spirits industry that is prominent in Kentucky, companies like Brown-Forman among others that are major players in the industry here in the United States, I get the sense looking at comparative tax structures between the Europeans where the English and the French are dominating acquisitions right now, that you can have two companies that have essentially the same level of competitive edge, of the ability to create margin if you will—and I am saying that outside the sense of a tax construct for a moment. But as I began to look at the advantage that a European company could bring to the table, specifically a British company in an acquisition versus an American company with the same revenues and general gross margins, it appeared to me in acquisition after acquisition that I looked at over the last several weeks, that the American company was at a 10 to 15 percent or more disadvantage in the offer that could be laid on the table for an acquisition. That has somewhat turned the tables, where we are

seeing American industries, let's say, being gobbled up in many aspects. Would you all like to comment on that?

Mr. EDGE. From a strictly British point of view, let me say that your fear is right. It does go back to the same thing. We have moved from a situation where the British competitors you are no doubt thinking of have had to run very, very hard with our CFC rules, (the equivalent of your deferral problem), to try to make sure the income is not currently taxable, and then find ways in which to move it around to keep the low effective tax rate to an exemption system is easier to deal with.

What I rejoice about now is that, with the work that was done by the last Labour government and the current Coalition, We have moved to a very sensible system. Life will tell us whether or not it is a good system for the U.K., but to me at present it seems like a good system and should make our multinationals more competitive, because deferral is not a feature and people can plan with much more certainty.

Mr. DAVIS. So you would say, then, that your tax system gives you a competitive advantage over us on the same playing field?

Mr. EDGE. Yes, I would. As I say, it is a part of the package and America has huge other strengths. But purely looking at it from a tax point of view, and knowing the little I know about the U.S. tax system, I would say where we have got to now is a very good place.

Mr. DAVIS. We don't like being in that place at the moment. I guess the question, and it is important in terms of international commerce, would it level the playing field in terms of the effectiveness of the global economy if we, too, had a territorial tax system here? Particularly from a standpoint of doing mergers and acquisitions?

Mr. EDGE. From my point of view, yes, it would. And of course as I have said a few times, it is part of the package. You have got things in your package that are pretty impressive. So whether the playing field would be level or tilted in your favor again, I am not sure. But on the tax side I think a level playing field would to my eyes be helpful.

Mr. DAVIS. We would like to keep our spirits industries owned by Kentucky companies right now, at least for a few specific brands.

Mr. Thomas, do you have a comment.

Mr. THOMAS. Yes, I definitely agree with Mr. Edge's comments. Businesses make, investment decisions on the basis of, after-tax return. And to the extent that American businesses are faced with a lower return as compared to foreign businesses, they are put at a disadvantage when they try to engage in these transactions. So I definitely agree.

Mr. DAVIS. I appreciate that perspective very much. Thank you. And, Mr. Chairman, I yield back.

Mr. TIBERI. [Presiding.] Mr. Doggett is recognized.

Mr. DOGGETT. Thank you, Mr. Chairman.

And thank you for your testimony. There are some here who believe that we ought to borrow from the Chinese and our other creditors or shift more of our tax burden onto small businesses and individuals so that a few large multinationals can pay even less than the relatively low effective rate that they pay today when they

pay taxes. General Electric and a few others don't even bother to do much of that.

In the cries for lower corporate tax rates, there is also the immediate demand for a rate of about 5 percent on previous earnings that have been accumulated abroad in what is called a repatriation tax holiday, but what is certainly not a holiday for most American taxpayers. At a cost of \$80 billion, we cannot afford to lower the corporate tax rate to 5 percent on the cash that multinationals have stashed in foreign tax havens.

At our last hearing, fortunately, all four corporate witnesses called by the Republicans agreed that such a stand-alone 5 percent repatriation tax break was a very bad idea, in the words of one of the witnesses, to which the other Republican witnesses agreed.

Whether we are discussing this immediate or more permanent changes in our tax laws, I believe the focus has to be whether we are encouraging jobs and growth in America or we are incentivizing the export of jobs and capital.

Mr. Avi-Yonah, you testified earlier about jobs. But let me ask you a more narrow question. Is adopting a territorial system an efficient way to create jobs in the United States?

Mr. AVI-YONAH. No.

Mr. DOGGETT. Will adopting a territorial system help us prevent multinationals from shifting billions of dollars out of the United States?

Mr. AVI-YONAH. No.

Mr. DOGGETT. And with reference to—you referred to transferral pricing rules. We know that we already have a system in place in which multinationals stash billions of dollars overseas and that not all of that money is on earnings overseas, but is in fact earnings from American consumers that have been categorized as foreign earnings.

Steve Shay, who was sitting in your chair not that long ago as the Department Assistant Secretary for International Tax Affairs, just recently again objected to the very territorial system being considered today and declared, quote: "No other country with an exemption system has successfully protected its domestic tax base from abuse. They all are struggling with transfer pricing."

Let me ask you, if I understand the way this great territorial system is going to work, the idea is if you have any earnings overseas, you don't owe any taxes at home on those. And if you have earnings at home, you pay whatever the statutory rate is, 25, 28, 30 percent. Doesn't that create a slight incentive, a more than slight incentive for a multinational to categorize earnings at home, particularly with intellectual property like a formula or trademark, as foreign earnings so they won't have to pay any taxes on it?

Mr. AVI-YONAH. Yes.

Mr. DOGGETT. So you referred to the current rules and their inadequacies. The effect of that in incentivizing the export of what are truly American earnings to tax havens only increases, doesn't it?

Mr. AVI-YONAH. Yes.

Mr. DOGGETT. Let me ask you also, we have heard the cries today right from this committee dais about American corporations having to pay 35 percent. And I am one who believes, as I think

every witness testified today, that we should be looking at the level of that statutory rate, even though few multinationals actually pay the statutory rate. But I want to be sure that I understand how that interfaces generally with our foreign tax credit rules.

If I understand, if a company packs up in Ohio or Michigan or Texas and moves those jobs to China and opens a factory over there, and they pay the Chinese 25 percent, 25 cents, say, on every dollar that they earn from their factory in China, the objection is that if they bring any of those profits back to the United States they have to pay 10 cents on the dollar here. Is that the way the system works?

Actually, I think that is a little too favorable to the corporations because there are all kinds of other gimmicks under the foreign tax credit rules, so you sometimes can get it even higher than the statutory rate in the country where the manufacturer is located. But is that generally how it works?

Mr. AVI-YONAH. Yes.

Mr. DOGGETT. Thank you.

Mr. TIBERI. The gentleman's time has expired. I recognize Mr. Reichert for 5 minutes.

Mr. REICHERT. Thank you, Mr. Chairman.

I want to thank the panel for being here today also. It is a great opportunity for all of us on the committee to hear from the different experiences that you had representing the countries and the organizations that you represent from around the world. I think it is a great opportunity for us to gain some wisdom from you, and I think that is always a good thing if we could have that sort of dialogue.

We may not adopt everything that Japan does or the Netherlands or Germany or the U.K., but certainly we can adjust things to fit the United States as other countries look at us and use some of those ideas here in the United States.

So that leads me to a question that is on a topic that is very near and dear to the hearts of those who live in the Northwest, and especially Northwest Washington where some of the most well-known tech companies are from, Microsoft and others. Congress, as you know, is considering a wide range of ideas looking at patent reforms to protect intellectual properties from counterfeiting and from theft. We are also looking at ways we might be able to encourage innovation in those areas. And, of course, as you know, innovation in America is one of our calling cards. We are proud of that and we want to encourage that.

I do understand that the Netherlands, and I think the U.K., has a special tax treatment that I think was referred to in one of the statements, an "intellectual property patent box."

Mr. Schoon or Mr. Edge, can you explain the concept of the patent box and the idea behind it to encourage keeping IP within your countries' borders, recognizing that it is a domestic tax proposal but there are some international implications? Can you address those two issues, please? Mr. Schoon, and Mr. Edge.

Mr. EDGE. Okay, I will start. Yes, I did refer to the patent box, and the patent box has been the result of quite a long and broad-spread inquiry in the U.K. into what we are doing about R&D. We have got some great companies there, particularly in the pharma-

ceutical area where R&D is important. And Sir James Dyson of vacuum cleaner fame has set up a committee to look at it in the U.K.

One of the conclusions on this was that this should be an area where we went beyond a level playing field on tax and went a little bit further to say, having had research and development credits over the years which have been enhanced deductions against tax, we should have a favorable tax regime for income from patents. It is quite limited. It is a 10 percent tax for income from patents that is received within the U.K., and a little bit (as I have referred in my testimony) like tonnage tax. So we have tax wrinkles, as you have in the U.S. as well. It is a rule that is designed to encourage activity in one particular area. And we are taking a gentle step in that direction.

It does also have international implications as well because in our CFC changes we are saying that that income from patents is good income or income from intellectual property is good income unless that intellectual property started off in the U.K. and has been exported.

So in those two ways we are trying to encourage innovation and not stifle our multinationals, but actually just give a little fillet to R&D in the U.K.

Mr. REICHERT. And you are looking at a law that may go into effect sometime in 2012; is that right?

Mr. EDGE. That is absolutely right.

Mr. REICHERT. Are you looking at the Netherlands' laws? I understand that the tax rate is 10 percent, I think, in the Netherlands also. You are looking at a 10 percent tax, too.

Mr. SCHOON. In the Netherlands it is 5 percent. It was reduced to 10 percent in 2007 and was reduced in 2010 to 5 percent at the same time the scope was broadened. It was limited to patents initially, self-developed patents. But it has broadened to certain specified R&D activities, development activities, but does not include trademarks, et cetera. It is focused on technology, including software.

Mr. REICHERT. Thank you, Mr. Chairman.

Mr. TIBERI. Dr. Boustany is recognized for 5 minutes.

Mr. BOUSTANY. Thank you, Mr. Chairman.

I thank the witnesses for your testimony. Critics of territorial systems argue that the systems oftentimes put excessive pressure on transfer pricing. Mr. Thomas, do you agree with that?

Mr. THOMAS. I think that it is fair to say that it puts some additional pressure because there is potentially a greater incentive to transfer profits overseas. However, the question is how much additional pressure, and how you take that pressure into account. There have been tremendous developments in the transfer pricing field in the past 10 years. Countries outside the U.S., countries all over the world, now are becoming very sophisticated. Companies have to deal with transfer pricing regulations not only in one country but in other countries as well. And the tax authorities are becoming more adept at evaluating transactions that may be abusive.

So, yes, I think there is greater pressure. But my own view is that that such pressure is not a sufficient justification to not change to a territorial system.

Mr. BOUSTANY. If we have a higher corporate tax rate, lowering corporate tax rates would obviously reduce some of that pressure on transfer pricing.

Mr. THOMAS. That is correct. And even though it was not directly related to the adoption of a territorial system, Japan has proposed a reduction in its corporate tax rates. It may be delayed now because of the disaster, but I believe that they will ultimately move ahead with that reduction.

Mr. BOUSTANY. Mr. Edge, do you agree with those comments?

Mr. EDGE. Yes, I very much agree on the comment on how tax authorities around the world have become much more sophisticated in dealing with transfer pricing. And with your comment—certainly from my experience in the U.K.—that, if you have a lower tax rate, there are still going to be some people who engage in tax avoidance because that is human nature. But the incentive to do so would be less.

In the U.K. the CFC regime has generally been kind to active income, and so transfer pricing has been very much a part of the U.K.'s protection, against the export of active income I don't see that changing.

And the other thing that has been a big change in the U.K. in the last 4 or 5 years is much more real-time working between the Revenue and the industry, which has really helped. There is a much more open, trustful relationship, no-surprises culture. That helps enormously.

Mr. BOUSTANY. I have heard mixed reviews about advanced pricing agreements, and I would like to hear each of your comments with regard to your experience.

Mr. Thomas, why don't you start?

Mr. THOMAS. Japan actually invented the advance pricing agreement back in 1986 when they adopted their transfer pricing rules. They called it the preconfirmation system. After a few years of perhaps mixed results, from about the mid-1990s, it has become a very successful program. Indeed, in Tokyo right now, there are more examiners becoming involved in the APA review process than there are in transfer pricing examinations. We are finding that APA renewals are becoming more easy to do and quite efficient. We are finding that other governments increasingly are adopting procedures for advance pricing arrangements, so these are being done on a bilateral basis more effectively and more efficiently. So I think there is tremendous promise in that program and that can also go a long way to help with the entire whole transfer pricing issue, including issues that may arise in connection with the adoption of a territorial system.

Mr. BOUSTANY. Mr. Schoon, what is your experience?

Mr. SCHOON. In the Netherlands it is very common to conclude advanced pricing agreements on transfer pricing matters. And that settles a lot of disputes in advance.

Mr. BOUSTANY. Thank you. Mr. Edge.

Mr. EDGE. APA transfer pricing agreements are invaluable in the financial services area. It has enabled banks to have a great deal of flexibility in running their operation.

Very useful also on inbound investments. A lot of U.S. companies coming to the U.K. have found the ability to clear the charging arrangements useful for headquarters and cost-plus operations.

Historically, since it came in about 5 years ago the APA regime has been more suspiciously treated in other areas but it is now becoming more common as the Revenue have got better at transfer pricing investigations. And any investigation is usually followed by an agreement for the future.

Mr. BOUSTANY. Mr. Menger.

Mr. MENGER. In Germany it is becoming more and more popular. APAs catching on slowly, but now it is very helpful for the taxpayer and the tax authorities because you have certainty about your international transactions.

Mr. BOUSTANY. I thank you. I yield back.

Mr. TIBERI. Thank you. Mr. Blumenauer is recognized for 5 minutes.

Mr. BLUMENAUER. I want to see if I can understand the context. Mr. Avi-Yonah mentioned the context of tax reform. Mr. Schoon, total taxes in the Netherlands approaches 40 percent of GDP; is that correct?

Mr. SCHOON. I do not have those statistical data available with me at this time.

Mr. BLUMENAUER. Well, I have here the OECD tax statistics database for 2008, before weird things happened, and it says in this that it was 39.1 percent total tax revenue as a percent of GDP. Is that reasonable? Is that in the ballpark?

Mr. SCHOON. As I said, I can't comment on that.

Mr. BLUMENAUER. You don't know? Okay. Let me turn, maybe Mr. Edge, if you have some sense of the total tax burden in the United Kingdom. The same chart suggests—not suggests, tells me that it is 35.7 percent total tax burden percentage of GDP. Is that reasonably accurate?

Mr. EDGE. I don't have it at my fingertips but that sounds about right. And it is clearly a figure that the government focuses on as times goes by, along with the balance between the different forms of tax that we have.

Mr. BLUMENAUER. Right.

Mr. Menger, in Germany it says 37 percent. Is that ballpark figure?

Mr. MENGER. I am not an economist and don't have the numbers at hand, but I believe it is an accurate number, yes.

Mr. BLUMENAUER. You are a tax expert.

Mr. Avi-Yonah, my chart here says that total tax percentage of GDP in the United States is 26.1 percent in 2008. Is that in the ballpark in your judgment?

Mr. AVI-YONAH. Yes.

Mr. BLUMENAUER. You in your final point, which you kind of rushed by in your testimony, you referenced the context of tax reform. Does the conversation that we are having this afternoon, does it make any difference that these other countries have much higher tax burdens on individuals and businesses, on managers and suppliers, when we are talking about both the impact of tax changes and the capacity to be able to make a tax change that, according

to Joint Tax, would cost \$80 billion a year to the Treasury? Could you talk a little about the context?

Mr. AVI-YONAH. I think that makes a tremendous difference. I mean the fact of the matter is that when American companies migrated, before we adopted the anti-inversion rules, they never inverted to Japan or to Germany or to the Netherlands or to the U.K.

They wouldn't dream of it because of these other taxes. I mean, the total tax burden on the headquarters of a multinational has to be measured to include the tax burden on the management and on the employees and the VAT that they all pay in all of these other countries. And you can't, in my judgment, talk about competitiveness in general in the abstract without taking all of these other taxes into account.

The other point, of course, is, despite, you know, the claim that the two things have nothing to do with each other, as a practical matter, if you are going to significantly reduce your revenues from the corporate tax to the tune of \$80 billion or more, it is helpful to have another tax that can be raised relatively easily to compensate for that. And that is what every other country does, but we don't.

Mr. BLUMENAUER. Thank you very much. I appreciate that.

Mr. Chairman, I think my friend, Mr. Doggett, pointed out that this would be the functional equivalent of a permanent repatriation—good, bad, indifferent. I mean, I just think our putting on the table what it means for the United States having a relatively lower tax burden than all these other countries—Japan more basically the same; it will be interesting to see how that retains over time, with exploding costs for an aging population in Japan—but the other three it seems pretty clear. And it seems to me important for us to try and understand the total context about what we would be getting into and what the likely consequence may be. And I think it is worth our exploring further.

Thank you, and I yield back.

Mr. TIBERI. Thank you.

And Mr. Buchanan is recognized.

Mr. BUCHANAN. Thank you, Mr. Chairman, for holding this important hearing today on taxes.

And I want to thank each of our panelists for being here today, also.

I believe we need to reform our Tax Code to get our economy going and get people back to work. But, Mr. Thomas, I noticed in your remarks you stated that the United States—its corporations struggle to deal with a very complicated and burdensome U.S. worldwide tax regime.

Would you all agree that our Tax Code is outdated and a barrier to economic growth or prosperity? That was kind of your conclusion. I just wanted to follow up on that point.

Mr. THOMAS. Yes, I would agree with that. I think, as we see what is happening around the world, all these countries that have for years had a territorial system or like the U.K. and Japan most recently, have gone through this thought process, have reached the conclusion to adopt a territorial system. And I think there is no reason why the United States shouldn't reach the same conclusion.

Mr. BUCHANAN. And along that line, what would be your couple of recommendations to us, as a panel, to supercharge or get our economy going or help our corporations worldwide?

Mr. THOMAS. Well, I think the adoption of a territorial system along the lines of what the U.K. or Japan has done, the dividend exemption, would encourage U.S. companies to bring their profits back into the United States and avoid the lockout effect.

Mr. BUCHANAN. And the other thing, I just wanted to touch base a little bit on Japan. I remember in the 1980s we had offices in California. It just seemed like Japan was going to own everything. How is their Tax Code there—has that made a difference? Has that bogged them down?

The reason I say that is because I remember, in the late 1970s, Hong Kong had a flat tax of 20 percent. And I was over there the other day, seeing they went to 16 percent. But with Japan keeping their rate, it seems, a little bit higher, has that made a negative impact? And then, do you agree that has affected us, as well, being competitive?

Mr. THOMAS. I think that it has had a negative impact. And that is why there were very strong calls in Japan, beginning a couple of years ago, to reduce Japan's corporate tax rates. Many of us were calling for a reduction closer to 10 percent, from the existing 40 percent. Ultimately, they decided to reduce the national corporate rate to 25 percent. So, all in, it is about 35 percent. But they did recognize that the current high rates were hurting them.

Mr. BUCHANAN. Yeah.

Mr. Chairman, I yield back.

Mr. TIBERI. Thank you.

Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chair.

And thank you all for being here.

In his prepared testimony, I believe it was Mr. Edge, who spelled out the real danger of having an uncompetitive tax system in an open economy like that of the United States and U.K. The fear is that our international competitors with a lower tax rate can afford to pay a higher purchase price when making acquisitions.

If U.S. companies become subsidiaries of foreign firms, their fair-market value might rise because they escape worldwide taxation. Studies have shown that foreign-based companies take over U.S.-based companies three-fourths of the time when there is a cross-border merger. The alternative to tax reform could be continually making our companies takeover targets.

Could you all elaborate on the role that tax reform could play in our increasingly competitive and global marketplace to put U.S. multinationals or future U.S. multinationals in a position where they are the acquirers, and not the targets, but also serves to protect our domestic tax base?

Mr. THOMAS. Yes, certainly, lower tax rates would increase after-tax returns for a particular investment. And, consequently, in order to be competitive, U.S. companies should be placed on the same level playing field as other countries around the world. The adoption of a territorial system would, in effect, result in foreign taxes being essentially the only taxes that would be paid in connec-

tion with those transactions and, again, would put U.S. companies in the same position as their competitors.

Mr. SCHOON. Again, speculation on what the U.S. should or should not do is not for me to do. But, as a general statement, a lower effective rate obviously increases your payback or your rate of return, as was earlier addressed.

Mr. EDGE. I think this is an "all-other-things-being-equal" question. But you are right, the drift of my testimony is exactly in that direction, because I have seen U.K. companies not able to make acquisition because other companies (rival bidders) have had better tax attributes. And I have also seen U.K. companies fall under foreign ownership, and then gradually you see businesses move out of the U.K.

So those fears are very real. But, as I say, it is "all other things being equal". Because if you are bringing other things to the table in innovation, capital market strength etc, then it may well be that you can outbid the tax system. But all other things being equal, it must be a positive move to lower the effective tax rate and make yourself more competitive so you become the acquirer and not the target.

Mr. MENGER. To acquire companies, you have to look at the return on investment and you have to look at the deductibility of interest. And both, of course, are affected significantly depending on what kind of tax system you have. And the better the return is, the easier it is to take over your competitors.

Mr. AVI-YONAH. I don't know of any evidence that cross-border M&A is driven primarily by tax considerations. It is driven primarily by business considerations. This is not the inversion saga, where this was purely a tax-motivated transaction.

Large cross-border M&A is driven by the ultimate needs of business to expand. And the United States is a very, very important market, the richest and biggest market in the world, so it is not surprising that foreign companies are interested in making acquisitions here in order to access our markets. I think that is a positive thing for the United States.

Ms. JENKINS. Okay. Well, it would seem that the tax bills of these major corporations would be a business decision, as well. So I think it would factor in when you call it a business decision, would it not?

Mr. AVI-YONAH. I don't think that the tax bill that American multinationals pay is significantly higher than the tax bill that foreign multinationals pay. So I think that these tax considerations are not particularly relevant because there is no evidence that I know of that shows that American multinationals are taxed more heavily than multinationals from other countries.

Ms. JENKINS. Okay.

One final question. It looks like we are running out of time. I am just wondering about exports. The President has stated that a goal is to double exports, and many of the companies that we have talked about indicate that they have more exports than the United States.

And maybe I will follow up in writing with you, because I hear the gavel. Thank you.

I yield back.

Mr. TIBERI. Thank you.

Mr. Kind is recognized.

Mr. KIND. Thank you, Mr. Chairman.

I want to thank the witnesses for your testimony and feedback I hear today.

Professor Avi-Yonah, let me start with you. Here is one of the concerns, and I know it is a little bit off-topic here today, and we are talking about corporate tax reform here. But the majority of businesses in America are passthrough entities, so the individual rate is terribly important. And yet, if you take a look at the overall corporate tax rate, the goal of trying to reduce it to the mid- to upper-20s, you know, if we got rid of all the tax expenditures on the corporate side, except for accelerated depreciation, the best we can do is a 31 percent rate. Getting rid of accelerated depreciation, we can get down to 28 percent.

Assuming we hit that mark, what would be the response with these passthrough entities, the majority of businesses in America, if we had a corporate rate at 28 percent with no expenditures at all on the corporate side?

Mr. AVI-YONAH. Well, I mean, I think the concern would be that the bigger the disparity between the rate that you impose on passthroughs and the rate that you impose on corporations, the more shifting there would be from one form to the other based primarily on tax considerations.

I mean, we used to have the system for many years where there was a huge—I mean, traditionally, the individual rate was much higher than the corporate rate. And the result was that a lot of earnings, even more than now, were parked maybe unnecessarily inside corporations and are not used in the best way that works for the economy.

Mr. KIND. Well, let me ask you, as well, because, you know, one of the difficulties that we have in dealing with this, if there is agreement that we should do it in a deficit-neutral fashion, is finding a way to pay for it. Obviously, the corporate tax expenditure is in one area, but that is only 8 percent of the entire expenditures in the U.S. Tax Code; 92 percent is on the individual side.

Should we be approaching this comprehensively, not just on the corporate but also on the individual side, given that, again, the majority of businesses are passthrough entities?

Mr. AVI-YONAH. I think it makes sense to address tax reform comprehensively and to address tax expenditures not just on the corporate side but other tax expenditures, as well, as the various deficit reduction commissions have proposed.

Mr. KIND. Well, I don't think it would go over very well, as far as the passthrough entities, if we started going to their side of the ledger in order to help pay for lowering of rates in the mid-20 range or something, which seems to be a goal that many of my colleagues are striving for.

So if we don't go to the individual side, we eliminate all of the corporate expenditures, again, that gets us, at best, to 28 percent. If you want to go lower than that, are there any other acceptable offsets to help pay for a lower rate? Should we be looking at cap gains, dividend, or both, dialing that in order to pay for a lowering of corporate tax rates?

Mr. AVI-YONAH. In my opinion, yes. I mean, I would increase the cap gain and the dividend rate in order to pay for corporate tax rate reduction.

Mr. KIND. Do our other witnesses have an opinion on that, as far as the dividend rate right now, as it currently exists, or the cap gain rate, as far as looking at that with the goal in mind of trying to simplify and lower overall corporate tax rates?

Mr. EDGE. I would be happy to make a comment based on the U.K. experience. I referred to Northern Ireland earlier on I did quite a lot of work there in the 1970s before the 1979 Conservative government came in with the objective of broadening the base and lowering the rates. And I found that Northern Ireland politicians were very much saying that if they had a high tax rate with grants or tax allowances for capital incentives, they ended up with investment coming in with significant risks attached—if you remember Mr. DeLorean, whose business wasn't terribly successful—where as Southern Ireland, with a lower tax rate for profitable companies, got people who didn't want somebody to risk-share on capital with them, but were very happy to know that they would make profits on which they would pay a lower rate.

So, as you probably guessed, I am afraid I am a completely unreformed lower-tax-rate person. If that means broadening the base by getting rid of deductions, that removes another form of distortion, as well.

Mr. KIND. Okay.

Well, Mr. Edge, let me just stay with you for a second. You know, one of the goals that we have with this, again, is overall tax simplification to make our companies more competitive and the ability for that capital sitting offshore coming into the United States.

Do you think just by going to a territorial system without recognizing the additional revenue forms that the developed nations have right now, the VAT being one of the primary ones, is a realistic approach for us to take here in the United States, I mean, with the budget deficits in mind that we are facing?

Mr. EDGE. I don't know, because I don't know actually what your fiscal constraints are. As I said, in the U.K., We have been able to bring exemption in without a big immediate fiscal cost. And the decision has very much been based on the fact that if you tried to raise more revenue from our big multinational corporates, you would be going completely in the wrong direction.

Mr. KIND. Well, I just hope we are not operating in a vacuum without recognizing the VAT and other forms of revenue that other nations are dependent on, as well.

But thank you, Mr. Chairman. Appreciate the time.

Mr. TIBERI. Thank you.

Mr. Paulsen is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman.

Also, thank you for all being part of this hearing and taking the time to testify. It has gone on for a while.

And I was just curious, because we have heard the perspective from Japan, Netherlands, England, Germany, et cetera, is any country that you are familiar with, whether it is among those individual countries itself or other countries that you are familiar with,

that are talking about going back from a territorial system to a worldwide system like the United States has?

Mr. THOMAS. I haven't heard of any countries thinking along those lines.

Mr. PAULSEN. Okay.

Mr. Schoon.

Mr. SCHOON. I am not aware of any.

Mr. PAULSEN. Mr. Edge.

Mr. EDGE. No, me neither. The French, as you probably know, have a "mondial" system, under which they treat everybody as being in France, (the best place to be of course!) but, as I understand it, they are not expanding that either.

Mr. MENGER. I am not aware of anybody.

Mr. PAULSEN. And thank you for that. It kind of underscores the point, the reason we are having this discussion is about competitiveness and what we can do to actually create jobs.

I know Mr. Avi-Yonah had a chance to answer the question earlier when one of my colleagues asked it, but based on the country you are familiar with, whether, again, Germany, Japan, Netherlands, England, adopted a territorial system if we in the United States, would that be an efficient way to help create jobs in the United States?

Mr. THOMAS. Well, I think if the United States takes into account the kind of considerations Japan took into account, that it would lead to the creation of jobs.

Mr. PAULSEN. Mr. Schoon.

Mr. SCHOON. You know, it is, again, a matter of U.S. tax law, which is very complex and there are a lot of factors, so I can refer to the Dutch experience, where we believe that is the case.

Mr. PAULSEN. Mr. Edge.

Mr. EDGE. By leveling the playing field for business investment and removing the threat on our multinationals, I believe it has a good tendency in that direction.

Mr. PAULSEN. Okay.

Mr. Menger.

Mr. MENGER. It is a very complex question. There are a lot of factors going in. And as a German tax expert, it is difficult to give you an answer to your U.S. question.

Mr. PAULSEN. Yeah. Well, there are a lot of complex factors as part of the U.S. Tax Code. It is a lot larger than the version you brought from Japan, certainly.

Can you also answer the question, will it help protect—potentially help protect American jobs and American jobs from being shipped overseas if we looked at moving to a territorial system?

Mr. Thomas.

Mr. THOMAS. Again, when Japan considered that question, they concluded that this is not a zero-sum game. They concluded that it is a win-win situation. It will take a lot of effort, but it is unavoidable that markets overseas are growing and that Japanese companies need to address that growth, and U.S. companies need to address that growth. And if they can take advantage of that growth effectively and then bring the profits back to the United States, that will serve to enhance the U.S. economy.

Mr. PAULSEN. Mr. Schoon.

Mr. SCHOON. The Netherlands, you know, has had these same considerations, and, as an open economy, has concluded that that would be the way to go.

Mr. PAULSEN. Mr. Edge.

Mr. EDGE. The U.K. benefits enormously from inward investment, particularly from the U.S. And I think anything that will foster that is a good thing and should be good for jobs. There is some paranoia about foreign ownership, and anything that actually preserves domestic control, some would say, is a good thing too.

Mr. PAULSEN. Mr. Menger, anything to add?

Mr. MENGER. I think it is helpful to generate jobs.

Mr. PAULSEN. Okay. And I know that a big conversation we are having is how to increase economic growth. I mean, I do agree with my colleague from Wisconsin's comments, too, about making sure that corporate tax reform is not the only provision that is on the table, because those small entities, partnerships, S corporations, et cetera, that pay under the individual rates, that has to be a part of the conversation for the foundations of overall tax reform, which I know our chairman is a part of, as well.

So thank you for your feedback and for being here today. I appreciate it.

I yield back, Mr. Chairman.

Mr. TIBERI. Thank you.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman.

I know the hour is late, and I want to thank all of you for your patience with the committee.

I find it difficult to just talk about corporate tax rates. In the United States, when we do tax reform, individual tax rates, politically, has to be addressed. But from what you are saying, it is like it is two separate issues, that you can just do the corporate rates and not the individual tax rate?

Mr. THOMAS. Well, Japan is undergoing a comprehensive review of its tax system. It has considered the corporate rates, it is considering individual rates and consumption taxes.

Mr. RANGEL. Would anybody consider just the corporate rates and not figure what the individual tax rates would be?

You would.

Mr. EDGE. Yes, I would, The government has of course to balance the books, which is the most important thing, and create the right infrastructure. But I would personally say that the corporate rates have to be set at a level that attracts investment and encourages global competition. And individual rates are affected by different things. They are part of the social responsibility.

So, personally, I think different factors come into play on individual rates and corporate rates. And, therefore, the two don't go into tandem. But, at the end of the day, the government has to—

Mr. RANGEL. If you were considering a deficit like we were and you wanted to see where the revenue would come from, would you not want to consider what percentage came from the individual tax rates and the corporate rates?

And, as some other Members have indicated, where we have a payroll tax for health care and Social Security, many European countries do not tax that directly and they just provide this service.

Mr. EDGE. I am sorry, is that for me?

I think, if I can say, sir, that that is a political question, and the answer to it will then have to be given having taken into account the economic consequences.

But, in answer to your first question, I believe that the corporate tax rate is something which you should look at economically first and then decide whether it is politically acceptable.

Mr. RANGEL. Well, since our economy is so much larger, I gather that you don't really think that the different sizes of our economy makes any difference as it relates to what the corporate structure looks like. But it would help me if, without going through it now and taking the committee's time, if you could tell me the percentage that your country receives from individual tax rates and the percentage it receives from corporate tax rates and whether or not there is a VAT or some other type of tax.

I assume you have a very high individual tax and low corporate tax, is that correct?

Mr. THOMAS. In Japan, the individual income tax yields about 13.5 trillion yen, the corporate tax about 7.8 trillion yen, and the consumption tax about 10 trillion yen in total.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. TIBERI. Thank you.

Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman.

Thank you for being here.

You know, I am interested in really the public perception, the dynamics that went into the tax reform change. And so, what was the public perception of your tax system before you did the reform?

Mr. Thomas.

Mr. THOMAS. The Japanese public perception of the tax system? I think that they feel that the income tax rates are high. I think it is fair to say the consumption tax is not the most popular tax, but they have become quite accustomed to it. And it is now, in Japan, required that the consumption tax be used to pay for national pension and health care for the elderly and senior care.

It is hard to say what the Japanese public thinks about the corporate tax. But Japan has had a very international-minded business community, and I think the Japanese public supports the Japanese companies' need to be able to compete effectively worldwide. And so, my sense is that they have a favorable view of the recent changes that have been made.

Mr. BERG. Thank you.

Mr. Schoon.

Mr. SCHOON. Well, the Netherlands, you know, as indicated earlier, the Netherlands did not go through tax reform to get to a territorial system because we have had that for a very long time. So it is engrained in the Dutch tax system, so that discussion did not take place in the last years.

Mr. BERG. And maybe what I am asking you is just the public perception now, then, of your tax system. You know, the average person, where are they at on it?

Mr. SCHOON. I think that, most times, the average person would think his own tax burden too high. Similar, yeah. But, over-

all, it is also a factor of the level of service that you get back for the taxes that you ultimately pay.

Mr. EDGE. The sort of issues we have been talking about today don't really translate terribly well into the popular press. How much tax banks should pay and how much tax bankers should pay is very much in the headlines, and the answer is a great deal.

If you were asking what the man in the street thinks about it, then I would say they react more to the notion of a well-known British name coming under foreign control and the implications that that then has on jobs than they do about what sort of corporate tax system we should have for multinationals.

But there is, nevertheless, a movement within the U.K., the U.K. Uncut system, which you have had, I think, some semblances of here, which looks at multinationals and it assumes if multinationals paid more tax, there would be less government cuts. But that is the only manifestation we have seen of a debate about the issues we have been talking about here in the popular sector.

Mr. BERG. Thank you.

Mr. MENGER. Yes, the German corporate system, corporate tax system, changed in the early turn of the century. The average man on the street doesn't really look into what the corporate tax issues are, is looking more at its own tax. And referring to what Frank already said, the tax is too high and it is too complicated with regard to individual taxation.

Mr. BERG. Thank you.

I will yield back, Mr. Chairman.

Mr. TIBERI. Thank you.

Mr. Pascrell is recognized.

Mr. PASCARELL. Thank you, Mr. Chairman.

I want to thank the panel.

I believe we come out of this, or at this, from two different perspectives, and that is very unfortunate. One picture is—and I will tell you, that is the approach I take to everything—income inequality; and your approach seems to be corporate disincentives. While one is not correct and the other incorrect, that is the way, you know, we approach this issue.

I have to respond, Mr. Chairman, to our gentlelady friend from Kansas who made some comments about corporate taxes, taxes on corporate income. Absolutely incorrect.

Mr. Avi-Yonah, correct me if I am wrong. It would seem, looking at the chart, of all of the countries that we trade with, major, major companies, 25 companies, that we have the lowest—that we have the lowest—taxes on a corporate income of any of those countries.

Mr. AVI-YONAH. As a percentage of revenue, that is correct.

Mr. PASCARELL. As a percentage of GDP.

Mr. AVI-YONAH. Yes.

Mr. PASCARELL. And that is because many of us are talking about, not the marginal rate, which we like to refer to but doesn't take into consideration the different deductions in each of the countries, which is the effective tax rate.

Mr. AVI-YONAH. Right.

Mr. PASCARELL. So I want to correct the record, Mr. Chairman. And I will stand corrected if I am wrong. I think that this is a very important point, and I bring this up for everyone's review. Looking

at all of our trade partners, we do not do very well. Or, rather—no, let's make a correction—we do do very well when we talk about the effective rate.

Now, I want to ask these questions.

Mr. AVI-YONAH, when we are shifting money out of the United States of America, that means that the filers here in this country, those people who file income taxes, pay more money in their taxes—must pay more money in their taxes to make up for the loss of revenue. Is or is not that correct?

Mr. AVI-YONAH. The government faces a certain amount of revenue that it has to raise every year. And to the extent that it under-collects from a certain sector, then it has to compensate. So I think that is correct.

Mr. PASCRELL. Gentlemen, don't you blame me for being concerned, or fault me for being concerned, that in New Jersey, the State that I am from, that State and the State of Delaware pay a lot more in taxes on individual filers because of this situation. In New Jersey, income tax filers pay \$752 more in taxes because of a system which I don't know whether we are advocating today or we are simply—the fault is not in the folks that represent companies that are in other countries. You are not the problem. We are the problem, we are the problem, in the direction and within the context that we are talking about.

And how is this paid for? This is paid for by those folks who do pay taxes in this country. And it particularly hurts New Jersey, which is the second worst in the entire Nation. I think we need to take a look at this. We need to look at this very, very, very carefully. When you look at what taxes are paid in the Netherlands or in Germany or in Japan, then you start to put things into context.

And I want to ask you this question, Mr. Schoon. How does your VAT work on an everyday commerce situation in the Netherlands? How does that work? Tell us.

Mr. SCHOON. The VAT is a tax that is levied in every chain of a supply chain or a production chain to the ultimate customer, where, in every step of the chain, the input VAT can be deducted. So that, in essence, only the value added will be taxed, and, in essence, it will be paid ultimately by the consumer, by the end consumer.

Mr. PASCRELL. Now, we don't have a value-added tax in the United States, do we?

Mr. SCHOON. No, you don't.

Mr. PASCRELL. We do not. You know our economic situation in terms of our trade, our imbalances. Would you recommend that we take a look at a VAT in this country?

Mr. SCHOON. I would think there is nothing wrong at looking at any other tax, including VAT.

Mr. PASCRELL. Thank you, Mr. Chairman.

Mr. TIBERI. Thank you.

To conclude today's questioning, Mrs. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman.

I thank all the panel members. I know it has been a long day for you. I sure appreciate your being here.

Given that all of the G7 countries have adopted a territorial tax system, do you think that the United States companies will have

more difficulty competing in the global marketplace if we continue to use the current worldwide tax system? And this would be for all the panelists.

Mr. THOMAS. Yes, I do. I believe that the world has changed, and unless the United States changes with it, U.S. companies will become less competitive.

Mrs. BLACK. Mr. Schoon.

Mr. SCHOON. Again, I cannot judge the U.S. side, as there are so many elements that play a role here. But, again, the Dutch experience was positive.

Mrs. BLACK. Thank you.

Mr. Edge.

Mr. EDGE. Tax is not the only or driving factor. It is not the predominant reason why people do things. But it is a swing factor. And the fact that other jurisdictions have gone in that direction tells you something. Having said which, I believe U.S. companies compete pretty well at present in the arena that I am in. But having gone through the U.K. process, I am a big, big advocate of a territorial system.

Mrs. BLACK. Thank you.

Mr. MENGER. Germany didn't change the system, but I believe, from comparing the two systems and being in Germany and in the United States, the territorial system is easier to deal with and should have less conflicts between taxpayer and the tax authorities.

Mrs. BLACK. Mr. Avi-Yonah?

Mr. AVI-YONAH. As I said before, I don't think territoriality, as narrowly defined here, has anything to do with the competitiveness of U.S. multinationals.

Mrs. BLACK. Thank you.

I yield back.

Mr. TIBERI. I first want to thank the panel not only for your insight today but your concise, clear answers. Frankly, a number of Members had two and three rounds of questions with each member of the panel; that is very rare. So commend you very much, both for the knowledge you imparted but also for the answers that you provided us.

And, also, I would say, Mr. Thomas, looking at the relative compactness of the Japanese Tax Code, I don't know whether to be inspired or depressed. Either way, we have some work to do.

With that, this meeting is adjourned.

[Whereupon, at 4:50 p.m., the committee was adjourned.]

[Questions for the Record follow:]

Gary M. Thomas—1

**TAX TREATY TREATMENT OF TAX CREDITS WHEN MOVING FROM A
CREDIT TO AN EXEMPTION SYSTEM
FOR MSSRS. THOMAS & EDGE**

Submitted by Chairman Dave Camp

Concerns have been raised about the status of the United States' tax treaty network if the United States moves from an international tax system that allows a tax credit to be taken for foreign income taxes paid, to a system that exempts certain dividends paid by foreign subsidiaries from taxation. As with many countries that tax worldwide income, U.S. tax treaties generally state that the U.S. will provide a credit against foreign income taxes. The Committee, however, is considering whether the U.S. should move to a system that provides an exemption for certain dividends paid by foreign subsidiaries, in lieu of a foreign tax credit. How did your country deal with its tax treaties when moving from a credit to an exemption system? Was this discussed, or will your tax treaties need to be renegotiated?

**Responses Concerning Japan
from Gary M. Thomas**

1. In brief, Japan takes the position that provisions in a tax treaty concerning foreign tax credits (including direct foreign tax credits and indirect foreign tax credits) are subject to the foreign tax credit rules in effect under its domestic tax law from time to time. Consequently, neither the elimination of the direct foreign tax credit for withholding taxes imposed on dividends from foreign subsidiaries which are exempt under the new foreign dividend exemption system nor the abolishment of the indirect foreign tax credit rules under Japanese domestic tax law were viewed as creating any requirement to renegotiate Japan's tax treaties.
2. Japan's tax treaties typically contain a clause concerning foreign tax credits which reads as follows:

“(S)ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan:

- (a) Where a resident of Japan derives income from the [Treaty Country] which may be taxed in the [Treaty Country] in accordance with the provisions of this Convention, the amount of the [Treaty Country] tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of the credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.
- (b) Where the income derived from the [Treaty Country] is dividends paid by a company which is a resident of the [Treaty Country] to a company which is a resident of Japan and which owns not less than [10 or 25] percent of the voting

- shares issued by the company paying the dividends during the period of six months immediately before the day when the obligation to pay dividends is confirmed, the credit shall take into account the [Treaty Country] tax payable by the company paying the dividends in respect of its income.
3. Several treaties contain foreign tax credit clauses which refer solely to direct foreign tax credits and do not mention indirect foreign tax credits.
 4. The "provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan" are found (with respect to corporations) in the foreign tax credit system in the Corporation Tax Law, comprised of both direct foreign tax credit rules and, prior to 2009, indirect foreign tax credit rules.
 5. Upon the adoption of the foreign dividend exemption system, Japan amended its foreign tax credit rules as follows:
 - (a) the indirect foreign tax credit rules were abolished (subject to certain transition provisions), and
 - (b) direct foreign tax credits were denied for foreign taxes imposed on dividends paid by foreign subsidiaries which are subject to the dividend exemption
 6. Direct foreign tax credits continue to be allowed for foreign taxes imposed on dividends paid by foreign subsidiaries which are not subject to the dividend exemption.
 7. The clear position in Japan concerning the relationship between a tax treaty and domestic tax law with regard to foreign tax credits is that, because the treaty contains the language "(s)ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan," in principle, no restrictions are imposed upon Japan under such foreign tax credit clause in a tax treaty regard to the contents of its foreign tax credit system in domestic tax law.
 8. Consequently, there was considered to be no need to renegotiate Japan's existing treaties due to the adoption of the foreign dividend exemption system which was accompanied by modifications to the foreign tax credit system in domestic tax law. New treaties simply do not include any reference to indirect foreign tax credits.
 9. Nevertheless, there was a concern for ensuring that the benefit of avoiding double taxation (albeit, through the foreign dividend exemptions rather than the foreign tax credit system) would be extended to dividends that had earlier been subject to the indirect foreign tax credit under treaties. Consequently, the 25% minimum shareholding threshold for applying the foreign dividend exemption is reduced to whatever ratio is set forth in a pertinent tax treaty for application of the indirect foreign tax credit system. Thus, for examples, dividends received by a Japanese parent company from a United States company in which it holds at least 10% of the shares will be subject to the foreign

dividend exemption. Treaty requirements for qualifying for the reduced shareholding ratios will be applied when making this determination.

10. Finally, Japan also adopts in principle the notion that taxpayers are allowed to elect to apply the more favorable of treaty rules or domestic tax law rules. However, notwithstanding that some taxpayers in limited circumstances might find the prior foreign tax credit rules to be preferable to the foreign dividend exemption system, the above-mentioned principle is not considered to apply in this kind of situation. Nevertheless, transition rules allow taxpayers to elect to continue to apply the indirect foreign tax credit rules to a limited extent after the adoption of the new rules.

-End

Gary M. Thomas—2

**COMPARATIVE CONTROLLED FOREIGN CORPORATION QUESTIONS
FOR MSSRS. THOMAS, EDGE, MENGER, AND SCHOON**

Submitted by Reps. Rangel, Stark, Blumenauer

How would the following situations be treated under your controlled foreign corporation (CFC) rules in Japan, the Netherlands, the United Kingdom, and Germany?

**Responses Concerning Japan
from Gary M. Thomas**

- a. P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply to attribute all of its profits (on a company basis) currently to its Japanese resident shareholders who either own, or belong to a single shareholding group that owns, directly or indirectly, 10% or more of its shares (hereafter referred to as "Japanese shareholders").

If all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders but, as described below, certain asset income may be attributable nevertheless.

The four tests are (1) the business activity test, (2) the physical facility test, (3) the management and control test, and (4) the unrelated person test (if the CFC is engaged in a prescribed business activity) or, alternatively, the location test.

A brief summary of the four tests is presented below:

- Business activity test: The CFC must not have as its principal business activity (i) the holding of shares, investments or debt securities, (ii) the provision of industrial property rights or copyrights, or (iii) the leasing of ships or aircraft.
- Physical facility test: The CFC must have a physical facility in its country of residence that is recognized to be necessary for the conduct of its principal business activity.
- Management and control test: The CFC's management and control must be conducted locally.
- Unrelated persons test: The CFC must engage in its principal business activity principally with unrelated persons, if its principal business activity is wholesaling, banking, trust management, securities, insurance, or sea or air transportation

- Location test: The CFC must engage in its principal business activity principally in its country of residence, if its principal business activity is one that is not listed under the unrelated persons test.

For reference, CFCs which are holding companies nevertheless are exempted from the CFC tax regime provided that the following criteria are met:

- The holding company must be owned 100% directly or indirectly by a Japanese corporation.
- The holding company must hold two or more controlled companies and conduct operations to control the business activities of the controlled companies. (A “controlled company” is a company which is owned 25% or more directly by the controlling company (the holding company) and carries out business activities having substance.
- The holding company must have fixed facilities and employees necessary to carry out the control activities.

It is noted that, in Case a, because the CFC is engaged in manufacturing, the location test (rather than the unrelated person test) would have to be applied.

b. Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies all of the four above-mentioned tests and avoids application of the CFC rules on an overall company basis, in the event that it has certain prescribed passive income, a special look-through rule for specified “asset income” would apply to attribute that income back to the Japanese shareholders.

Specified asset income consists of the following:

- Dividends from corporations in which the shareholding is less than 10% of the outstanding shares
- Interest on debt instruments
- Income from the redemption of debt instruments
- Gains from the sale of shares of corporations in which the shareholding is less than 10% of the outstanding shares (limited to transfers on securities exchanges or over the counter)

- (v) Gains from the sale of debt instruments
- (vi) Income from the provision of patents, utility model rights, design rights, trademarks and copyrights (excluding income arising from property that was developed by the CFC itself, property purchased by the CFC and used in its business, and property licensed by the CFC and used in its business)
- (vii) Income from the leasing of ships or aircraft

For purposes of computing the amount of profits attributable to shareholders, certain expenses related to the above income may be deducted.

For reference, income in categories (i) through (v) above arising from operations which are “basic, important and unavoidable based on the characteristics of the business carried out” by the CFC, except for specified businesses (i.e., holding of shares or debt securities or provision of industrial property rights, etc.), is excluded from this attribution rule.

With regard to Case b, interest income from lending funds to unrelated persons outside X would not fall within the specified interest described above that is subject to the asset income attribution rules.

For reference, the larger of the following de minimus amounts is also excluded from this asset income attribution rule:

- revenue amounts pertaining to asset income attributable from the CFC which is 10,000,000 yen or less
- revenue amounts pertaining to the asset income attributable from the CFC which is 5% or less of its book profits

- c. **Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.**

Response:

Japan’s CFC rules apply a trigger rate of 20% in determining whether profits are to be attributed to Japanese shareholders in the case that CFC fails any one of the four prescribed tests described above. This 20% rate is computed based on the “effective” tax rate, not the statutory tax rate. In addition, the effective tax rates are to be calculated pursuant to Japanese domestic tax law. Effective tax rates of 20% or less are considered to constitute an extremely low tax burden as compared to the taxes on corporate income in Japan.

Consequently, even if the statutory tax rate in the CFC’s country is 25%, a tax holiday would reduce the effective tax rate to zero, in which case the 20% trigger would apply.

- d. Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.**

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC would not be attributed back to the Japanese shareholders.

Nevertheless, the royalty income from the provision of industrial property rights and copyrights would be includable in specified asset income and subject to attribution unless this royalty income arises from property that was developed by the CFC itself, property purchased by the CFC and used in its business, or property licensed by the CFC and used in its business.

- e. Same as (a), except that the CFC earns interest derived from another CFC controlled by P.**

Response:

In the case that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company-wide basis would not be attributed back to the Japanese shareholders.

Nevertheless, if the interest derived from another CFC controlled by P is includable in specified asset income, it would be subject to attribution under the asset income attribution rule. In order to be subject to attribution, it would have to be interest on debt instruments, not merely interest on a loan.

- f. Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.**

Response:

In the case that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC would not be attributed back to the Japanese shareholders.

In Case f, if the CFC is engaged in purchasing and selling as its “principal business activity,” the unrelated person test would have to be applied.

- g. Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.**

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Because the CFC is predominantly engaged in the banking business, it would be subject to the unrelated persons test and would satisfy that test.

As the CFC conducts a substantial activity with respect to such business, it is likely to satisfy the physical facility test and probably the management and control test.

Since it is not engaged in a business described under the business activities test, the CFC satisfies that test.

As a result, the CFC would not be subject to the attribution rules on a company basis.

However, if the CFC has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

h. Same as (a), except that the CFC is an insurance company.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies the four tests, if it has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

Response:

In the event that the CFC fails to satisfy any one of four prescribed tests for avoiding the application of the CFC regime, the CFC regime would apply. However, if all of the four tests are satisfied, then the profits of the CFC on a company basis would not be attributed back to the Japanese shareholders.

Nevertheless, even if the CFC satisfies the four tests, in the event that it has income that qualifies as specified asset income, it would be subject to the asset income attribution rules.

Interest earned from lending to P would not fall within income subject to the asset income attribution rules.

-End

Frank Schoon

House Ways and Means Committee Hearing

“How Other Countries Have Used Tax Reform to

Help Their Companies Compete in the Global Market Place and Create Jobs”

May 24, 2011

Response to Questions Submitted to Frank Schoon by Reps. Rangel, Stark, and Blumenauer

The following written submission responds to an August 17, 2011 letter from Chairman Dave Camp (R-MI) requesting my response to a series of questions relating to controlled foreign corporation (CFC) rules in the Netherlands as they would apply to several specific fact patterns.

Overall Comment

In my written testimony the key elements of the Dutch tax system are described. Before responding to the specific questions I first will reiterate some relevant passages from my written testimony.

Dutch tax law does not include special provisions for “controlled foreign companies” (i.e. there are no controlled foreign corporation or Subpart F rules). Dutch resident entities are subject to corporate income tax on their worldwide profits, and non-Dutch resident entities are subject to corporate income tax in the Netherlands on income derived from certain specific sources within the Netherlands, but with provisions to prevent double taxation of business profits.

With respect to the questions raised, the Dutch participation exemption is the relevant provision incorporated in Dutch tax law that deals with the prevention of double taxation. Under the application of the participation exemption all income (i.e. dividends, capital gains (or losses), currency gains (or losses) and other profit distributions) realized by a taxpayer with respect to a qualifying participation is fully exempt from Dutch tax. To qualify for the participation exemption the “ownership test” and one of the “motive test”, the “asset test” or the “subject to tax test” must be met. If the participation exemption is not applicable because the required tests are not met, the taxpayer is required to mark to market its investment on an annual basis if the taxpayer holds an interest of 25% or more in the investment, the investment is not subject to a reasonable level of tax according to Dutch tax principles and 90% or more of the investments assets consist of low-taxed portfolio investments.

In general a foreign tax credit of 5% or the actual underlying tax under EU Parent-Subsidiary Directive is available on income (grossed up with a factor of 100/95) derived from an investment that does not qualify for the participation exemption unless that investment is not subject to corporate income tax.

Specific Questions and Answers

In the absence of CFC rules in the Netherlands, I will respond to the questions from the perspective of the application of the Dutch participation exemption.

- a. P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- b. Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.*

The participation exemption should apply at the level of P on its investment in the CFC if the finance activity 1) is in line with the business of P, 2) is part of the business of the CFC, or 3) is considered 'active' for Dutch tax purposes, because the ownership test and either the asset test or the motive test should be met. In those cases, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- c. Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- d. Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.*

If the royalty income is earned from a license provided to a related party which qualifies as 'active' for Dutch tax purposes, or from a license to an unrelated party, the participation exemption should apply at the level of P on its investment in the CFC, because the ownership test and either the asset test or the motive test should be met. In those cases, all income

derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

The participation exemption would not apply at the level of P on its investment in the CFC if the only activity of the CFC is licensing to related parties which does not qualify as 'active' for Dutch tax purposes. In such a case where the participation exemption is not applicable, P would be required to mark to market its investment on an annual basis because P holds an interest of 25% or more in the CFC, the CFC is not subject to a reasonable level of tax according to Dutch tax principles, and 90% or more of its assets consist of low-taxed portfolio investments. Given that the CFC is not subject to corporate income tax, no foreign tax credit would be available.

e. Same as (a), except that the CFC earns interest derived from another CFC controlled by P.

If the second CFC is a subsidiary of the first and less than half of the aggregated assets of both CFCs consist of low taxed passive assets (e.g. low-taxed receivables from the second CFC), or generally if the finance activity is considered 'active' for Dutch tax purposes, the participation exemption should apply at the level of P on its investment in the CFC, because the ownership test and either the asset test or the motive test should be met. In those cases, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

If the second CFC is not a subsidiary of the first, the participation exemption would not apply at the level of P on its investment in the CFC if lending funds to related parties is the only activity of the CFC, unless the finance activity of the CFC is considered 'active' for Dutch tax purposes. In such a case where the participation exemption is not applicable, P would be required to mark to market its investment on an annual basis because P holds an interest of 25% or more in the CFC, the CFC is not subject to a reasonable level of tax according to Dutch tax principles and 90% or more of its assets consist of low-taxed portfolio investments. Given that the CFC is not subject to corporate income tax, no foreign tax credit is available.

f. Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- g. Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- h. Same as (a), except that the CFC is an insurance company.*

If the CFC is comparable to a true third party insurance company, the participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. In that case, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

- i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met, provided that the finance activity does not exceed the manufacture/sales activity of CFC. In that case, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

TAX TREATY TREATMENT OF TAX CREDITS WHEN MOVING FROM A
CREDIT TO AN EXEMPTION SYSTEM
FOR MSSRS. THOMAS & EDGE

Submitted by Chairman Dave Camp

And answered by Stephen Edge in bold below

Concerns have been raised about the status of the United States' tax treaty network if the United States moves from an international tax system that allows a tax credit to be taken for foreign income taxes paid, to a system that exempts certain dividends paid by foreign subsidiaries from taxation. As with many countries that tax worldwide income, U.S. tax treaties generally state that the U.S. will provide a credit against foreign income taxes. The Committee, however, is considering whether the U.S. should move to a system that provides an exemption for certain dividends paid by foreign subsidiaries, in lieu of a foreign tax credit. How did your country deal with its tax treaties when moving from a credit to an exemption system? Was this discussed, or will your tax treaties need to be renegotiated?

The UK has not had to change its double tax treaties. The reason for this is that most of the UK's treaties are like that between the United Kingdom and the USA and so provide that credit for foreign taxes is only to be allowed within any constraints provided therefor in United Kingdom law and also that credit is required to be given only against UK taxes on the same income. Where a dividend from overseas does not qualify for exemption under our new territorial regime (possibly because of the application of certain anti-avoidance rules), these rules will continue to operate and credit will be given in accordance with domestic law against UK tax on the same income. Where, however, the foreign dividend is exempt, then there will be no foreign tax credit claim to be made because of the absence of UK tax on the same income and there will also be no spill-over of unused foreign tax credits against UK tax due on other income because of the "same income" limitation. In most cases, therefore, the treaty credit provisions will simply have become irrelevant and will thus be redundant.

Steve Edge—2COMPARATIVE CONTROLLED FOREIGN CORPORATION QUESTIONS
FOR MSSRS. THOMAS, EDGE, MENDER, AND SCHOON

Submitted by Reps. Rangel, Stark, Blumenauer

And answered by Stephen Edge in bold below

[Note, in relation to these questions, that the UK situation is complicated at present by the fact that UK law has been successfully challenged in the European Courts and is also in the process of change through ongoing government consultation. These questions could thus be answered under existing UK statute law, under such UK statute law as amended by conforming interpretation as a result of the European Court of Justice judgment or by reference to the most likely outcome of the current consultation process. Rather than give three possible answers, what is set out below reflects the most likely outcome of the proposals the government has made for future CFC rules in the UK. It is hoped that this will be the most relevant and helpful information to provide in this context.]

How would the following situations be treated under your controlled foreign corporation (CFC) rules in Japan, the Netherlands, the United Kingdom, and Germany?

- (a) P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.

So long as the profits made by the CFC are commensurate with its assets or attributes and activities in X, income earned by the CFC from its manufacturing activities should not be subject to CFC apportionment despite the fact that the products are being sold back to P and X has no income taxation.

- (b) Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.

If, as well as carrying on a manufacturing activity, the company receives "incidental investment income" (not more than 10% of its turnover is one proposal that has been put forward), the position will be as in (a). To the extent that additional investment income in excess of the safe harbour arises, however, that will be treated as a coming from a separate activity and could be subject to CFC apportionment.

The government proposes to introduce a finance company regime which, by incorporating maximum capitalisation requirements, effectively means that eligible finance companies will be subject to an effective UK tax charge of 5.75% on underlying interest income by the year 2014. Again, the level of taxation in X will not affect this analysis. Some consideration is also being given to the possibility of a wholly exempt offshore finance company regime (something many commentators believe to be justified by the Cadbury decision in the European Court). However, it

is not yet clear that a CFC which carries on a trade will be able to fall within the finance company regime.

- (c) Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.

Same answer as (a).

- (d) Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.

The answer here will depend upon the nature of the IP from which royalties are earned and how the income arises. If the IP has been generated and is maintained by expenditure and efforts wholly outside the UK, the answer in (a) will continue to apply. The position where IP is generated or maintained to a significant extent by UK activities is still under review but there may be a CFC charge if it has.

- (e) Same as (a), except that the CFC earns interest derived from another CFC controlled by P.

If, as well as carrying on a manufacturing activity, the company receives "incidental investment income" (not more than 10% of its turnover is one proposal that has been put forward), the position will be as in (a). To the extent that additional investment income in excess of the safe harbour arises, however, that will be treated as a coming from a separate activity and could be subject to CFC apportionment.

The government proposes to introduce a finance company regime which, by incorporating maximum capitalisation requirements, effectively means that eligible finance companies will be subject to an effective UK tax charge of 5.75% on underlying interest income by the year 2014. Again, the level of taxation in X will not affect this analysis. Some consideration is also being given to the possibility of a wholly exempt offshore finance company regime (something many commentators believe to be justified by the Cadbury decision in the European Court). However, it is not yet clear that a CFC which carries on a trade will be able to fall within the finance company regime.

- (f) Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.

If the CFC is not manufacturing but is still carrying on a commercial activity, the position should still be as in (a) so long as the CFC's profits are commensurate with its assets or attributes and activities. The fact pattern here would, however, require it to be clearly demonstrated that there was a genuine commercial activity being carried on in X and that the CFC was adding value.

- (g) Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.

Special rules are proposed for companies carrying on genuine banking activities. If they are regulated, it is unlikely that their commercial profits would be subject to CFC apportionment.

- (h) Same as (a), except that the CFC is an insurance company.

Special rules are proposed for companies carrying on regulated insurance businesses – insurance outside the regulated sector would potentially be subject to apportionment unless another exemption (such as the general purpose exemption that looks at whether or not a business is genuinely carried on in an overseas territory and whether the profits generated are commensurate with the activities) applies.

- (i) Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

There are no specific rules in the UK which treat upstream loans as a dividend. However, upstream loans can, under the worldwide debt cap regime, affect the amount of overall interest deductibility for the group concerned in the UK. There is also the possibility that income from upstream loans will be specifically targeted by the new CFC regime. Even without such targeting, however, interest income from upstream loans will either have to be protected under the incidental income rules or will be potentially subject to CFC apportionment (possibly at the lower rate applicable under the finance company regime) unless the general purpose exemption applies. Apart from that, the position should be the same as in (a).

Jörg Menger

**House Ways and Means Committee Hearing
 “How Other Countries Have Used Tax Reform to
 Help Their Companies Compete in the Global Market Place and Create Jobs”
 May 24, 2011**

Response to Questions Submitted to Jörg Menger by Reps. Rangel, Stark, and Blumenauer

In the following, I respond to the questions included with the August 17, 2011 letter from Chairman Dave Camp (R-MI), which concern the controlled foreign corporation (CFC) rules in Germany as they would apply to several specific fact patterns.

Overall Comment:

The questions posed refer to a CFC’s country of residence “X” as a “country with no income taxation” or a country with income taxation at the same rate as is imposed on the parent company, P, but with a “10 year tax holiday entitlement” (see question c. below). For purposes of my response, I have assumed that X is not a member state of the European Union (EU) or the European Economic Area (EEA), because all EU and EEA jurisdictions generally have a system of income taxation and do not extend significant tax holiday benefits. In the event that X would be an EU or EEA member state, the German CFC rules generally would not apply if the CFC carries out a meaningful economic operation in its country of residence (referred to as the “EU / EEA exception”). Given the above, I have not included in my response any comments with respect to the potential applicability of the EU / EEA exception.

Specific Questions and Answers:

How would the following situations be treated under your controlled foreign corporation (CFC) rules in Germany?

- a. P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.*

The German CFC rules subject so called “passive” income of a CFC to current taxation at full rates at the level of the German parent. They do not apply to “active” income of a CFC. Income from “industrial” operations is defined as active income, and manufacturing operations are generally considered “industrial” operations. Therefore, income of the CFC is not subject to taxation under the CFC rules if such income is derived from manufacturing.

Income from a CFC’s trading operations with German residents or parties related to the CFC, however, is only treated as active income if the CFC maintains a qualified fully operational trading business with typical operational trading functions (such as marketing, customer service, warehousing, payment administration, etc.), and is participating with that business to a material extent in general commercial trading operations with third parties and third party customers. P

would bear the burden of proof for the existence of such a qualified commercial trading operation.

In the current case, the CFC would be considered to pursue both a manufacturing operation and a trading operation. In those cases where the CFC manufactures or otherwise processes goods, and resells them to a related or German resident party, the operation is treated in its entirety as industrial if, as judged by generally accepted industry standards, the nature of the CFC's manufacturing operation exceeds the level of immaterial manufacturing procedures, and creates articles with a different marketability quality. Mere marketing, repackaging, refilling, sorting and compiling acquired goods as well as affixing brand or control marks would not meet this standard and would not qualify as manufacturing in this context.

Assuming that the CFC's manufacturing of widgets meets the materiality test, all the income of the CFC would be considered "active" income from industrial operations, and would not be subject to taxation under the CFC rules. If the manufacturing materiality test is not met, all the income of the CFC would be considered trading income, and would be taxed at the level of P at full German rates under the CFC rules, unless P provides proof that the CFC maintains a qualified commercially established trading operation.

- b. Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.*

Under the German CFC rules, interest income generally is considered passive income, and is subject to taxation at full German rates at the level of P, unless one of the following exceptions applies:

- i) The CFC maintains a fully operational banking business which participates in general commerce and either the lending of the funds qualifies as a banking business operation or the interest income constitutes income on capital maintained for regulatory purposes. Note that the banking business exception does not apply if more than 50% of the CFC's banking business transactions are carried out with related parties.
- ii) The CFC qualifies as an "active" finance company. Active finance company status requires that both of the following requirements are met:
 - the CFC proves that the loaned funds were solely sourced on foreign capital markets and were not provided by a related party; and
 - the CFC proves that it loaned the funds to related or unrelated non-German resident businesses which derive 90% or more of their gross receipts from operations which qualify as "active" under German CFC rules (industrial / manufacturing operations, commercial trading and commercial service, banking and insurance, etc.).

- c. Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.*

If the manufacturing income qualifies as "active" income, the income would not be subject to CFC taxation, irrespective of the 10 year tax holiday (see above response to question (a)). In the event that the CFC's income would not qualify as active income because the manufacturing materiality test is not met, the rules applicable to passive income would apply.

German CFC rules for passive income include a "high tax kick out" rule. The rule stipulates that passive income of a CFC is not subject to taxation under the CFC rules, if the CFC income is taxed by the country of its residence at an effective tax rate of at least 25%. Whether or not an effective rate of 25% or more is present is determined by applying German tax accounting rules. Because German tax law does not provide for a tax holiday, the CFC's effective tax rate in this situation is below 25%. Thus, the CFC's income would be subjected to German taxation at full rates at the level of parent P under the CFC rules, unless such income qualifies as active income from manufacturing (see above comments to question (a)).

- d. Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.*

Royalty income is generally treated as active income if it is derived from the licensing or utilization of intangible assets which were developed or created by the CFC's own business without the material assistance of a related party. Assuming that this is the case, the royalties would not be subject to taxation at the level of P under the CFC rules.

- e. Same as (a), except that CFC earns interest derived from another CFC controlled by P.*

The interest income would be subject to taxation at full rates at the level of Parent P under the CFC rules, unless either the banking business exception or the active finance company exception applies (see above response to question (b)) or the exception for certain ancillary income applies. Under the ancillary income exception, interest income of the CFC would not be subject to taxation at the level of P under the CFC rules if the income is ancillary to an active income item (e.g., interest customarily paid on a short term trade receivable, which stems from a qualified trading business operation).

- f. Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.*

In this situation, the CFC generates trading income. Trading income would only be active income if the CFC maintains a qualified fully operational trading business, and if P can prove the existence of such a qualified trading business (see above response to question (a)). Otherwise, the income would be subject to taxation at full rates at the level of P under the CFC rules.

g. Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.

Assuming that the CFC meets the active banking business exception (see above response to question (b)), the CFC's income would not be subject to taxation at the level of P under the CFC rules.

h. Same as (a), except that the CFC is an insurance company.

Income from insurance operations is considered "active" if the CFC maintains a fully operational insurance business which participates in general commerce and the operation qualifies by its nature as an insurance operation or the income constitutes income on capital maintained for regulatory purposes. As with the banking business exception, the insurance business exception does not apply if more than 50% of the CFC's insurance transactions are carried out with related parties. If the CFC's income is considered active under the insurance operation rule, the income would not be subject to taxation at the level of P under the CFC rules.

i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

The lending of earnings from a CFC to its parent generates income subject to taxation at the P level under the CFC rules only with respect to any interest income that is earned by the CFC on the loan transaction (see above response to question (e)).

Asian American Hotel Owners Association, Statement



Asian American Hotel Owners Association

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May 20, 2011

Rep. Dave Camp (4th-MI), Chairman
Rep. Sander Levin (12th-MI), Ranking Member
Ways and Means Committee Office
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Corporate Tax Code Reform

Dear Chairman Camp and Representative Levin:

The Asian American Hotel Owners Association (AAHOA) strongly urges Congress to reform the United States corporate tax code with the goal of becoming internationally competitive.

AAHOA has more than 10,000 members who own more than 20,000 hotels in nearly every American community. According to a recent PKF Consulting study, AAHOA member-owned hotels are worth \$128.7 billion. AAHOA members employ 578,600 full and part-time workers, with a \$9.4 billion payroll and \$31 billion on operating expenses. We are small business owners whose success is directly tied to a growing U.S. economy.

The current corporate tax code puts American business at a significant disadvantage when compared to most industrialized nations. We know America can compete and win on an international basis if we are not constrained by an antiquated tax code.

A pro growth tax code will lead to more jobs, more economic activity, more international investment, and most importantly, more long-term growth for the American economy. The time for action is now!

America's current corporate tax rate is among the highest in the industrialized world. Moreover, our major trading partners, including Canada, Britain, and Japan have all recently cut, or announced plans to cut, their corporate tax rate for the specific purpose of creating domestic jobs and growing their respective economies. Inaction by Congress will only mean the United States falls further behind our competition.

AAHOA stands ready to help lead the way in returning the American economy to high levels of sustained growth. We urge Congress to help make this happen by reforming our corporate tax code.

Regards,

ChandraKant (CK) Patel AAHOA Chairman	Hernant Patel Vice Chairman	Atkesh Patel Treasurer	Mehul (Mike) Patel Secretary	Fred Schwartz President

The Center for Fiscal Equity, Statement

Comments for the Record

House Ways and Means Committee

**Hearing: How Other Countries Have Used Tax Reform to Help Their
Companies Compete in the Global Market and Create Jobs**

May 24, 2011

**by Michael Bindner
The Center for Fiscal Equity**

Chairman Camp and Ranking Member Levin,
Thank you for the opportunity to submit my comments on this topic.

I will leave it to others to describe how other companies compete and confine my remarks to how the United States should restructure its tax system with an eye to both competitiveness and how other countries should respond to what I propose.

There is more to tax reform than international competitiveness, as tax policy takes a back seat to factor prices in determining where retailers seek their suppliers, unless of course this committee is willing to enact a substantial value added tax to decrease imports and decrease exports. I do not believe that is the intention of the Committee, at least not at this time.

Tax reform, if undertaken at all, should have the goal of simplifying the collection of revenue while maintaining or improving its basic progressive structure (which in current law is more honored in its breach, given low taxes on capital gains and dividends). The use of the tax code to provide subsidies to working families must be maintained, but this should occur without requiring that every household file a tax return to receive them, often by paying others to do so and paying a premium for refund anticipation loans which are heavily marketed to those least able to afford the finance costs.

On the other hand, the number of people paying no tax as a result of these benefits has justly drawn criticism that a sense of shared sacrifice has been abandoned. This has led many to demand some form of consumption tax so that all are conscious of some sacrifice. Some form of visible consumption tax will also provide an incentive to save to those who otherwise would not because their incomes are too low to do so. The wealthy, however, need no such incentive – having the ability to satisfy all of their current economic needs with additional income to spare.

To satisfy both demands, the Center proposes a four part tax structure.

Part One is a Value Added Tax (VAT), which is suggested because of its difficulty to evade, because it can be as visible to the ultimate consumer as a retail sales tax and because it can be

zero rated at the border for exports and collected fully for imports. As this feature has been well explained by others, I will not go into detail on this point. What is more important is to exercise care in delineating what is funded by such a tax.

We believe that VAT funding should be confined to funding domestic discretionary military and civilian spending. Zero rating a tax supporting such spending is totally appropriate, as foreign consumers gain no benefit from these expenditures. Likewise, making imports fully taxable for this spending correctly burdens the consumers who fully benefit from these services. As importantly, making such a tax visible provides an incentive to taxpayers to demand less of such spending.

An extreme example of such spending incentives would be the creation of a regional VAT funding regional appropriations, with varying rates depending upon spending levels. While creation of regional appropriations panels and government agencies can be accomplished under the *Constitution* as currently written, creation of any regional excise would require a constitutional amendment, as the *Constitution* requires all excises to be uniform.

In order to fully fund current domestic obligations, the Center calculates that the tax rate should be 13.3%. In order for this to be affordable, during the transition, income tax withholding tables should be adjusted to increase net income by the same percentage, with Social Security beneficiaries receiving a similar bump in payments. This is a "balanced budget" rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Two is a VAT-like Net Business Receipts Tax (NBRT). Its base is similar to a VAT, but not identical. Unlike a VAT, and NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The key difference between the two taxes is that the NBRT should be the vehicle for distributing tax benefits for families, particularly the Child Tax Credit, the Dependent Care Credit and the Health Insurance Exclusion, as well as any recently enacted credits or subsidies under the *Patient Protection and Affordable Care Act (ACA)*. In the event the ACA is reformed, any additional subsidies or taxes should be taken against this tax (to pay for a public option or provide for catastrophic care and Health Savings Accounts and/or Flexible Spending Accounts).

The Child Tax Credit should be made fully refundable and should be expanded to include revenue now collected under the dependent exemption, the home mortgage interest deduction and the property tax deduction. Transitioning these deductions will allow a \$500 per month per child distribution with payroll. It will likely increase incentives to expand affordable housing and may not decrease housing for the wealthy, who are less likely to forgo vacation housing or

purchase of luxury housing for want of a tax cut, as the richest families likely pay the alternative minimum tax anyway, so that they do not fully use this tax benefit now.

This tax should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

An extreme example of this proposal is to have a differential regional rate and differential benefit levels for this tax, which may or may not require an amendment – as this tax may be far enough removed from the transaction level to be considered an income tax rather than an excise.

Again, in the extreme, this tax could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions.

Employers receive a tax credit if their retirees opt out of Medicare and Medicaid for seniors by fully employer funding of retiree health care, either by hiring doctors or purchasing comparable coverage, including catastrophic coverage in return for some kind of tax credit. ***This proposal is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise.*** While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

It is not appropriate for this tax to be zero rated, as doing so would decrease the incentive to pass these tax benefits to employees. As importantly, the tax benefits and government services provided under this tax go to workers and their families. As such, overseas purchasers accrue benefits from these services and should therefore participate in their funding.

If the NBRT is enacted in this way, the United States should seek modification to our trade agreements to require that similar expenditures not be funded with taxes that are zero rated at the border. As foreign consumers benefit from subsidies for American families, American

consumers benefit from services provided to overseas workers and their families. This benefit should be recognized in international tax and trade policy and American workers should not be penalized when other nations refuse to distribute the cost of benefits to foreign workers to the American consumers who receive the benefit of these services. If our trading partners do not match this initiative, some items of spending could be shifted from NBRT funding to VAT funding, so that we are not making unilateral concessions in this area.

The VAT would replace income taxes collected at the lowest rate, while the NBRT would replace disability insurance, hospital insurance, the corporate income tax, business income taxation through the personal income tax and the mid range of personal income tax collection, effectively lowering personal income taxes by 25% in most brackets. Note that collection of this tax would lead to a reduction of gross wages, but not necessarily net wages – although larger families would receive a large wage bump, while wealthier families and childless families would likely receive a somewhat lower net wage due to loss of some tax subsidies and because reductions in income to make up for an increased tax benefit for families will likely be skewed to higher incomes. For this reason, a higher minimum wage is necessary so that lower wage workers are compensated with more than just their child tax benefits.

The NBRT rate is projected to be 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Three is the continuation of a payroll tax for Old Age and Survivors Insurance (although insurance for survivors under age 60 may be shifted to the NBRT). Given the across the board decrease in gross income, the tax rate would have to be increased to 6.5% for employees and employers (provided younger survivors are excluded). To improve program progressivity, the employer contribution could be credited on an equal basis, moving redistributive effects from benefit distribution to revenue collection. Additionally, the amount subject to tax should be increased or the income cap eliminated, which would help both program income and support for lower income retirees.

Separation of this tax from the NBRT is necessary unless the employee contribution is to be totally eliminated with a uniform benefit or uniform. A separate payroll contribution is required as long as benefit levels are set according to income. If a uniform benefit is desired, then payroll taxes can be discontinued and the NBRT expanded. Employee contributions could not be zero rated at the border. If employer contributions are equalized and contributed to a public system, however, they could be incorporated into a VAT rather than an NBRT. This allows the Social Security system to benefit from foreign labor where outsourcing has occurred. Indeed, it would be an essential expansion of the tax base if globalization is to continue unabated.

The prospect of Personal Retirement Accounts can also be considered, although doing so is like holding a lightning rod in a thunderstorm. I do agree with President Obama that such accounts

should not be used for speculative investments or even for unaccountable index fund investments where fund managers ignore the interests of workers. Investing such accounts in insured employee-ownership of the workplace would have an entirely different outcome, especially if voting shares occurred on an occupational basis with union representation. The impact at the international level of such employee-ownership if extended to subsidiaries and the supply chain is also potentially profound, especially in regard to transfer pricing and the international growth of the union movement. Those interested in my thoughts on this issue can contact me for more information.

Part Four is surtax on high income earners and heirs. It would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay a surtax on that income. We considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

This surtax could have few rates or many rates, although I suspect as rates go up, taxpayers of more modest means would prefer a more graduated rate structure. The need for some form of surtax at all is necessary both to preserve the progressivity of the system overall, especially if permanent tax law enacted before 2001 is considered the baseline (which it should be) and to take into account the fact that at the higher levels, income is less likely to be spent so that higher tax rates are necessary to ensure progressivity.

This tax would fund net interest on the debt, repayment of the Social Security Trust fund, any other debt reduction and overseas civilian, military, naval and marine activities, most especially international conflicts, which would otherwise require borrowing to fund. It would also fund transfers to discretionary and entitlement spending funds when tax revenue loss is due to economic recession or depression, as is currently the case. Unlike the other parts of the system, this fund would allow the running of deficits.

Explicitly identifying this tax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other

nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards. The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1961 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall. Additionally, as foreign labor markets mature, foreign workers will demand more of their own productive product as consumers, so depending on globalization for funding the deficit is not wise in the long term.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

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The Chamber of Commerce, Statement



Statement
of the
U.S. Chamber
of Commerce

ON: How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market and Create Jobs

TO: House Committee on Ways & Means

DATE: May 24, 2011

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Camp, Ranking Member Levin, and Members of the Committee, the U.S. Chamber of Commerce greatly appreciates the opportunity to comment on how we can reform the tax code¹ to help companies compete in the global market and create jobs.

INTRODUCTION

We live in an increasingly global economy. Technology advances have changed the way business works. Unfortunately, the U.S. tax code has not kept pace. It is plagued by problems – including a too high tax rate, a bias against capital investment, an outdated worldwide system of taxation, and excessive complexity. As other countries have reformed their tax systems, our failure to make similar reforms threatens the ability of American companies to compete, deters foreign investment in the United States, decreases capital investment, and risks American job losses.

MARGINAL TAX RATES

The Chamber believes that tax reform legislation should lower the corporate tax rate to a level that will enable U.S. businesses to compete successfully in the global economy, attract foreign investment to the United States, increase capital for investment, and drive job creation in the United States. Congress also should consider the impact of a corporate rate reduction on passthrough entities.

OECD Country Comparisons

The U.S. tax code is lagging sadly behind its worldwide competitors. The U.S. top marginal corporate tax rate, at 35 percent, is completely out of step with other major industrialized OECD nations. As noted by the Tax Foundation,² a nonpartisan organization:

[T]he simple average of non-U.S. OECD nations has fallen from 38 percent in 1992 (the first year in which it fell below the U.S. rate) to 25.5 percent today. Similarly, the weighted average—which accounts for country size—has fallen from 42.5 percent in 1992 to 30.1 percent today. The weighted average rate of non-U.S. countries fell below the U.S. rate in 1998. Thus, 2011 marks the twelfth straight year in which the U.S. has been above the weighted average rate.

Further, as noted in another Tax Foundation study,³ we not only shackle our businesses with high rates, but we have taken no action to lower our rate as other countries have acted. As the study notes, “[i]n the past four years alone, 75 countries have cut their corporate tax rates to make themselves more competitive.” Our major trading partners— Canada and Great Britain – have already taken steps to make themselves more competitive by dropping their corporate tax rates, while the United States has done nothing to reduce rates.

¹ All references to the code are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

² See Tax Foundation, Fiscal Fact No. 261, Countdown to #1 : 2011 Marks 20th Year That U.S. Corporate Tax Rate Is Higher than OECD Average, available at <http://www.taxfoundation.org/publications/show/27100.html>.

³ See Tax Foundation, Special Report No. 191, Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings, available at <http://www.taxfoundation.org/files/sr191.pdf>.

In Canada, the business tax rate was reduced from 18% to 16.5% on January 1, 2011. Further, the government plans to lower it to 15% of business profits as of January 1, 2012. This tax cut is Canada's fourth in recent years and will lower its federal corporate income-tax rate from the current 18% to less than half of the U.S.'s 35%. The Canadian government has stated that these cuts will give Canada the lowest overall tax rate on business investment in the Group of Seven Industrialized Nations when deductions and credits are factored in.⁴

The United Kingdom also has taken rate reduction measures in recent years. British Chancellor George Osborne recently cut the corporate tax rate to 26% from 28%. A one-point cut to 27% had already been planned. In addition, Osborne said the rate would be cut by one point in each of the following three years, bringing it to 23%. Osborne has noted that other countries have been "quite deliberately" making their tax systems more competitive to attract multi-national companies.⁵

PassThrough Entity Considerations

In addition to small businesses being impacted because they operate as part of larger companies' supply chains, the Chamber believes Congress would be remiss to take action to reform the code for businesses operating in C corporation structures while ignoring those operating in passthrough form. While passthrough entities exist worldwide, they are extremely prevalent in the United States and, thus, the impact of tax reform on businesses operating in passthrough structures must be given careful consideration.

According to a recent study by Ernst & Young, more than 90 percent of businesses in the United States are organized as flow-through entities. That study also found that individual owners of passthrough entities paid 44 percent of all federal business income taxes between 2004 and 2008 and, moreover, that passthrough businesses employ 54 percent of the private sector work force in the United States.⁶ Flow-through businesses are a critical source of job creation and innovation in the United States that cannot be ignored in fundamental tax reform.

Under current law, the same top marginal income tax rate of 35% applies both to corporations and pass-through entities. In addition, business tax expenditures included in the code apply to both corporations and flowthrough businesses. If corporate tax reform takes place separate from individual tax reform, pursuant to which the corporate rate is lowered in exchange for the elimination or reduction of business tax expenditures, passthrough entities will lose the

⁴ See Dvorak, "Canada Slashes Business Levies," *Wall Street Journal* (12/30/10), available at <http://online.wsj.com/article/SB10001424052970203525404576050080874854882.html>. See also "Manufacturers rally behind importance of business tax cuts," CME News (1/26/11), available at <http://www.cme-mec.ca/?action=show&lid=JCKNC-E742G-1W6JA&cid=S1BRV-5JA8C-XF48P&comaction=showhttp://www.cme-mec.ca/?action=show&lid=JCKNC-E742G-1W6JA&cid=S1BRV-5JA8C-XF48P&comaction=show#http://www.cme-mec.ca/?action=show&lid=JCKNC-E742G-1W6JA&ci>.

⁵ See "Osborne to cut UK's company tax rate," RTE News (3/23/11), available at <http://www.rte.ie/news/2011/0323/britain-business.html>.

⁶ Carroll and Prante, "The Flow-Through Business Sector and Tax Reform," April 2011, available at <http://www.scorp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf>.

benefit of business tax expenditures without a corresponding rate reduction. Piecemeal corporate tax reform thus could have a negative financial impact on passthroughs, putting jobs at risk.

TAXATION OF FOREIGN SOURCE INCOME

In the international arena, the Chamber believes that the current worldwide tax system should be replaced with a territorial system for the taxation of foreign source income to enable U.S. businesses to compete successfully in the global economy, as well as domestically against foreign firms, and to promote economic growth domestically.

For U.S. companies to compete in global markets, they need a level playing field. In 2011, the United States suffers not only the second highest corporate tax rate in the world but is the only major industrialized OECD country that continues to employ a worldwide system of taxation.⁷ This high tax rate and possibility of double taxation, while mitigated by provisions such as deferral and the foreign tax credit, harms the ability of U.S. companies to compete against foreign companies who face little or no home country tax.

In recent years, countries seeking to see their domestic companies succeed in global markets have shifted to territorial systems of taxation. For example, Great Britain adopted a quasi-territorial system of taxation and continues to make changes to shift closer to territorial tax system.⁸ The driving force behind this change was to make Great Britain more competitive and to reduce compliances costs.⁹ Further, in 2009, Japan also shifted to a territorial tax system.¹⁰ Key factors in this decision were Japan's desire to see foreign profits reinvested domestically and to encourage domestic intellectual property investments.¹¹

While the Chamber urges a shift to a territorial system of taxation, we also believe that the details of a territorial system are of the utmost significance. Proper consideration must be given to issues such as the specific exemption system applicable to foreign dividends, the treatment of other foreign income, exceptions to the exemption regime, the use of foreign tax credits for income that continues to be subject to foreign tax levies, and the treatment of expenses. These issues are unquestionably complex but must be addressed if the United States wishes to keep pace in the global economy.

R&D INCENTIVES

⁷ See Tax Foundation, Special Report No. 191, Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings, available at <http://www.taxfoundation.org/files/sr191.pdf>.

⁸ See Tax Foundation, "U.K. Strives to have "Most Competitive Tax System Among G20," available at <http://www.taxfoundation.org/blog/show/27157.html>.

⁹ See Wilson, "Open for business," *The Sun* (5/20/10), available at <http://www.thesun.co.uk/sol/homepage/news/money/2980284/George-Osborne-Corporation-tax-to-be-lowest-in-G20.html>. See also "Lessons in Reform—Discussion of Recent Tax Reform in Other Countries," TCPI 11th Annual Tax Policy and Practice Symposium (Statement of Anneli Collins).

¹⁰ See Ernst & Young, "International Tax Alert: Japan's move to territorial taxation contrasts with US international tax policy," available at <http://tax.ey.com/NR/rdonlyres/edb7ggulansyuajnmmscid3lcobk6ap35suar4geem22gu5bvacg3r52522yugcoujqtmppkniq4qf4zw5sz4zuuayd/TA077.pdf>.

¹¹ See "Lessons in Reform—Discussion of Recent Tax Reform in Other Countries," TCPI 11th Annual Tax Policy and Practice Symposium (Statement of Jonathan Stuart-Smith).

The Chamber has long advocated that research and development (R&D) expenses should be deductible in the year incurred and a larger credit for increases in research expenditures should be allowed. Further, as other countries expand R&D benefits, the Chamber believes we should consider how the tax code impacts the decision whether to conduct research and development in the United States and, also, where the ensuing intellectual property that is created is located.

A recent Information Technology and Innovation Foundation paper¹² notes the decline in tax incentives to conduct R&D in the United States. Noting that the United States was the first country to implement a R&D tax credit in 1981, the paper concludes that we have failed to keep pace globally with R&D tax incentives. Examining our position globally it concludes:

By 1996 the United States had fallen to seventh in R&D tax generosity among the 30 OECD nations, behind Spain, Australia, Canada, Denmark, the Netherlands, and France. And the slide continued. By 2004 we had fallen to 17th. Even with the recent expansion of the ASC from 12 to 14 percent the United States was only able to hold position at 17th (and 19th for small businesses R&D incentives), as other nations also expanded their R&D tax incentives. However it is not just OECD nations that have overtaken the United States, a number of other nations, including China, India, Brazil, and Singapore, provide more generous tax treatment for R&D expenditures.

The Chamber believes that innovation is a crucial long-term driver of growth and jobs. Any reform to the tax code should contain incentives for companies to conduct research and development activities in the United States and locate the resulting intellectual property within U.S. borders.

OTHER CONSIDERATIONS

While issues such as marginal rates, systems of taxing foreign source income, and R&D incentives easily lend themselves to international comparisons, certain other issues are more challenging to quantify and thus contrast. These issues are, nonetheless, highly relevant and merit consideration.

Certainty

The Chamber believes that any changes should be permanent to ensure certainty for businesses striving to expand, create jobs, and remain competitive in the United States and abroad. We believe that U.S. companies are disadvantaged by not only high rates and our system of taxing foreign source income, but also by the uncertainty that results from the temporary nature of so many crucial business tax provisions.

Since 1986, the code has seen over 15,000 changes, and, as of last count at the end of 2010, contained 141 temporary provisions, such as the CFC look-thru rule active financing

¹² See Information Technology and Innovation Foundation, "17 is Not Enough: The Case for a More Robust R&D Tax Credit," available at <http://www.itif.org/files/2011-17-is-not-enough.pdf>.

exception, which generally require annual renewal by Congress.¹³ As other countries have introduced tax reforms and provided detailed information on when such reforms will be implemented, the Chamber urges Congress to create the same certainty in the United States to allow for the most efficient business decisions and effective long term planning.

Simplification

The Chamber believes Congress should enact simple, predictable and easy to understand tax rules to improve compliance and reduce the cost of tax administration. As noted above, other countries, such as the United Kingdom, have carefully considered compliance burdens in shifting to new systems of taxation. The Chamber urges Congress to give the same weight to this issue in considering reforming the tax code.

Cost Recovery

In addition to reducing tax rates, the Chamber believes that tax reform should eliminate the bias in the current U.S. tax system against capital investment. Capital investment should be expensed or recovered using a capital cost recovery system that provides the present value equivalent to expensing with due regard to the impact the system may have on cash flow.

Transition Rules

The Chamber believes that comprehensive tax reform should include realistic transition rules to provide adequate time for implementation and help minimize economic hardships businesses may encounter in transitioning to the new tax system.

CONCLUSION

The Chamber thanks Chairman Camp, Ranking Member Levin, and Members of the Committee for the opportunity to comment on tax reform. As Congress considers possible fundamental tax reform, the Chamber believes lowering the marginal tax rates, shifting to a territorial tax system, and addressing the uncertainty of our code are critical matters. We appreciate the continued discussions the Committee is having on these issues and look forward to our continued work with Congress on these issues.

¹³ See, e.g., Hearing Statement of Senator Max Baucus (D-Mont.), Regarding Changes in the Tax Code since the 1986 Tax Reform Act, *available at* <http://finance.senate.gov/imo/media/doc/03012011%20Baucus%20Hearing%20Statement%20on%20Changes%20in%20the%20Tax%20Code%20since%201986%20Reforms.pdf>.

The Securities Industry and Financial Markets Association, Statement

STATEMENT ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS
ASSOCIATION

SUBMITTED FOR THE RECORD OF THE HEARING
ON

“HOW OTHER COUNTRIES HAVE USED TAX REFORM TO HELP THEIR COMPANIES COMPETE
IN THE GLOBAL MARKET AND CREATE JOBS”

BEFORE
THE COMMITTEE ON WAYS AND MEANS

ON
MAY 24, 2011

Introduction

The Securities Industry and Financial Markets Association (SIFMA)¹ welcomes the opportunity to provide comments for the record on the May 24, 2011 Committee on Ways and Means (“Committee”) hearing to “examine international tax rules in various countries with an eye toward identifying best practices that might be applied to international tax reform in the United States.”² As the Committee examines the feasibility of adopting a dividend exemption system that would move the United States closer to a territorial tax structure, a critical design element is whether interest expense will be disallowed in calculating exempt dividend income. At this time, SIFMA is not prepared to make general recommendations as to the future direction of U.S. international tax policy. As the Committee considers a dividend exemption system, however, we do have a view regarding the importance of heeding “lessons learned” by other countries that have adopted dividend exemption systems. In this regard, we urge the Committee to reject rules to allocate and disallow a portion of a company’s global interest expense. A dividend exemption regime that includes interest allocation and disallowance would almost always result in financial businesses losing U.S. interest deductions regardless of whether U.S. borrowings have any relation to exempt foreign earnings.

¹ SIFMA represents the shared interests of hundreds of securities firms, banks and asset managers, with the mission to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. With offices in New York and Washington, D.C., SIFMA is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

² <http://waysandmeans.house.gov> (Hearing Advisory; accessed 18 May 2011).

Additionally, and in view of the Committee's focus on "policy choices that maximize competitiveness and job creation,"³ we would like to share a comparative analysis of how selected countries with dividend exemption systems have treated interest expense of financial services firms that are headquartered in those countries.⁴

U.S.-headquartered SIFMA members that are global financial services firms have a particular concern that some may view the interest allocation rules that were developed in the United States for the limited purpose of calculating allowable foreign tax credits as an appropriate basis for disallowing interest deductions related to exempt dividend income.⁵ For this reason, SIFMA organized a working group of member firms to evaluate options for an alternative to the application of the U.S. interest allocation rules. As a first step, the SIFMA working group surveyed the rules addressing home country interest expense under dividend exemption systems in six countries. The survey covered France, Germany, Switzerland, and the United Kingdom ("UK") in Europe, and Japan and Australia in the Asian-Pacific area.

As explained more fully below, none of the six countries limit the deductibility of interest expense directly. Rather, three of the six use the indirect approach of reducing the percentage of exempt dividends by 5 percent as a proxy for allocating expenses to exempt dividend income; two of the countries do not use a proxy (although one of the two does disallow interest allocable to foreign permanent establishments if the company elects to treat the income of that branch as exempt); and one (Switzerland) reduces qualifying dividend income by a portion of the shareholder's interest expense for the year in which dividends are paid (so interest expense is fully deductible in years in which no exempt dividends are received).

While none of the countries have adopted rules for allocating home country interest expense to foreign exempt income, SIFMA found that the countries have adopted various special rules for addressing the potential that companies might over-leverage their home country activities to capitalize foreign subsidiaries, resulting in interest deductions in the home country that could potentially erode the home country revenue base. Even here, however, these countries recognize that interest incurred by financial services companies essentially represents the "cost of goods sold," and so their "thin capitalization" ("thin cap") or interest cap regimes are either generally

³ *Id.*

⁴ In conjunction with this hearing, the staff of the Joint Committee on Taxation published JCX 33-11, "Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income," which provides only a general overview of the exemption systems in selected countries.

⁵ *Cf.* The proposal to defer deductions of interest expense related to income eligible for deferral under current law, included in the Administration's Budget for fiscal year 2012, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, Department of the Treasury (February 2011) 40-41.

designed to have little impact on financial services firms, or include special provisions to exempt most financial services activities. Similarly, all the countries include rules to differentiate between interest income that might be passive, taxable income for industrial companies and active business income for financial services companies.

I. THE SELECTED DIVIDEND EXEMPTION REGIMES

Although the selected regimes differ in their details, they all provide an exemption from the home country's income tax for dividends derived from active business income, where such income is distributed by a controlled foreign corporation ("CFC") to a multinational corporation ("MNC") that is organized there or otherwise treated as resident. The next discussion summarizes the following: the scope of the exemptions provided; the extent to which interest expense allocation rules are used; limitations on the deductibility of interest expense (including the significance of non-tax financial regulatory rules); special rules for financial services firms; and any anti-avoidance provisions.

II. EXPENSE ALLOCATION RULES

As a proxy for disallowance of expenses such as interest, dividend income received by an MNC from its CFC is 95 percent exempt in France, Germany, and Japan; in Switzerland, the UK, and Australia, 100 percent of qualifying income is exempt. Although Switzerland does not have any interest disallowance rules, interest expense — and charges such as administrative expenses — have the potential to dilute the dividend exemption because a portion of a Swiss MNC's shareholder interest expense is deducted from gross dividend income to calculate "net qualifying dividend income."⁶ This rule only applies to expenses for the year in which qualifying dividends are paid, so interest expense is fully deductible in years in which dividends are not paid. In any case, a special rule for banks limits their reduction of qualifying dividends to two-thirds of financing costs.

In view of the 5 percent taxability of dividend income in France, Germany, and Japan, it is not surprising that these countries do not provide any special rules to disallow the deduction of interest expense by a resident MNC. The same is true of the UK, although it provides a 100 percent exemption without reduction for deemed expenses.⁶ Australian results are similar to those in the UK; although a loss or expense that an Australian MNC incurs in deriving non-

⁶ The UK government recently reviewed its treatment of interest expense and concluded that there should be no significant changes to the UK's "competitive regime for interest," reflecting the fact that a territorial approach to interest expense relief would be complex and difficult to manage. Note the discussion in section IV below, however, about the UK's targeted anti-avoidance provisions aimed at restricting interest deductions in certain scenarios. HM Treasury, "Corporate Tax Reform – delivering a more competitive system," (November 2010), page 30.

taxable income generally does not qualify for a deduction, an MNC resident in Australia is entitled to a deduction for interest incurred in deriving exempt dividend income from foreign subsidiaries. In those countries in which 95 percent of foreign earnings is subject to exemption, a foreign tax credit is not allowed for the portion that is taxable in the home country, further indicating that the taxable portion really is acting as a proxy for disallowing domestic expenses that may be attributable to exempt income.

Similarly, capital gain on the sale of shares in foreign subsidiaries can qualify for the applicable exemption in France, Germany, the UK, Switzerland (in the case of pure holding companies), and Australia; Japan is the exception. Generally, where capital gain would be exempt, capital losses from the sale of shares are not deductible (as in Germany and France, for example).

III. LIMITATIONS

The SIFMA working group also examined whether the six countries apply debt or thin cap rules to MNCs headquartered in that country to protect the domestic tax base. The group found that the UK, France, Switzerland, and Australia have thin cap regimes. Germany uses a general interest expense limitation rule. The sixth country, Japan, uses thin cap rules to limit the deductibility of interest paid on related-party debt by Japanese subsidiaries of foreign MNCs (similar to the U.S. earnings stripping regime under I.R.C. §163(j)). Significantly, however, *all of these jurisdictions provide special rules to accommodate the fact that financial services firms are highly leveraged*. Finally, the group also considered whether the tax regimes rely in any way on financial regulatory rules to determine whether a financial services firm is over-leveraged in the home country relative to its foreign operations.

A. Germany's General Interest Expense Limitation

Under the German regime, interest expense remains fully deductible up to the amount of accrued or received interest income, and beyond that (*i.e.*, the remaining net interest expense) up to 30 percent of taxable EBITDA.⁷ Germany's general interest expense limitation rule does not apply if, *inter alia*, the company belongs to a worldwide consolidated group and its ratio of equity to the total balance sheet at the end of the prior fiscal year is equal to or greater than that of the consolidated group (escape clause).⁸ Also, disallowed net interest expense (excess net interest expense) can be carried forward indefinitely and deducted in later years as interest, in addition to a five-year excess EBITDA carry forward. Generally, a group of German companies that form a

⁷ For completeness purposes it should be noted that, if interest expense is not subject to the general limitation rule, it may be subject to 25% add-back for trade tax purposes. The add-back for trade tax purposes is subject to a special relief rule, if the taxpayer is a bank or certain financial enterprise (e.g. registered leasing companies).

⁸ An equity percentage of up to 2 percentage points below that of the group is acceptable.

tax-consolidated group (*organschaft*) that does not consolidate for accounting purposes with any other entities is excepted from the interest expense limitation rule (standalone exception).

Germany does not provide a special rule for financial services firms, but such firms, in general, would have sufficient interest income to offset interest expenses, and hence no particular relief rule is necessary.

B. "Thin Cap" Regimes

1. General Rules

The UK uses a "worldwide debt cap" regime that restricts interest deductions of a UK group where the UK net debt of the group exceeds 75 percent of the worldwide gross debt of the group. Effectively, the application of the worldwide debt cap regime is limited to interest paid on loans from a related party.⁹ Additionally, the UK applies transfer pricing provisions that require arm's length interest rates for intra-group financing. It also has a targeted anti-avoidance provision that restricts tax deductions for interest expense incurred in respect of a loan whose purpose includes an unallowable/tax avoidance purpose or where there is "international arbitrage."

France also uses thin cap rules, but these rules can be avoided if the debt-to-equity ratio of borrowers corresponds to the shareholders' equity ratio of their groups. Application of the French rule is limited to interest paid on loans from a related party (generally determined by reference to 50 percent of the borrowing company's share capital) and debt that is (directly or indirectly) guaranteed by a related party. Where the French rule applies, the deductibility of arm's length interest expense is limited to the greater of the following three amounts:

- Interest on 1.5 times the borrower's net equity;
- 25 percent of net-adjusted income before tax; or
- Interest income received from related parties.

Nondeductible interest may be carried forward indefinitely and used against up to 25 percent of current income under the French rules.

Like the French regime, the Swiss federal thin cap rules are also limited to the interest expense on debt from related parties; however, the methodology differs. Essentially, the Swiss guidelines prescribe a specified percentage of assets that may be financed by debt from related parties, with percentage that vary depending on the asset type.

⁹ If a UK group has no related party interest expense then the worldwide debt cap regime does not apply. If a UK group has disallowed interest expense pursuant to the worldwide debt cap regime, the group can choose what interest expense is disallowed, including interest expense paid to unrelated parties. However, the maximum amount of interest expense that may be disallowed is limited to the net interest expense paid by the UK group to related parties.

The Australian thin cap rules are aimed at ensuring that entities do not allocate an excessive amount of debt to their Australian operations. These rules are based on a concept of “maximum allowable debt”; an entity will not violate the thin cap requirement if its “adjusted average debt” does not exceed its “maximum allowable debt.” This rule applies to both inbound and outbound companies. For Australian-based companies with investments and operations outside of Australia, there are three approaches to calculating the maximum allowable debt:

- *Safe harbor debt level.* Very broadly, this is calculated as 75 percent of the Australian group’s assets, less non-debt liabilities.¹⁰ Because the maximum allowable debt calculation excludes the value of controlled foreign entity equity, an Australian company will erode its thin capitalization (or be in breach) on a 1:1 basis where leverage is used to fund a foreign controlled entity.
- *Statutory arm’s length debt level.* Broadly, this is the amount of debt capital (includes loans as well as equity instruments that satisfy the statutory debt test) that would be lent to an entity by an independent commercial lending institution, if the borrower and notional lender were dealing at arm’s length in respect of the Australian business assets.
- *Worldwide capital amount.* Broadly, this rule allows the *entity to leverage its Australian operations* up to 120 percent of the actual leverage of its worldwide group.

An Australian group of which 90 percent of its assets are domestic and is not controlled by non-Australian entities is exempted from the Australian thin cap rules.

2. Special rules for a financial services business

The UK, France, Switzerland, and Australia provide special rules to take account of the leverage that is a necessary part of a financial services business:

- The UK worldwide debt cap regime does not apply to qualifying financial services groups; qualifying activities include lending, insurance activities, and relevant dealings in financial instruments, but not asset management related activities.
- The French thin capitalization rules do not apply to “credit” institutions (such as banks, financial companies, and other entities listed by the relevant regulator as a “credit establishment,”) or to financing granted by a Treasury Finance Center company in the course of a group centralized treasury agreement (*i.e.*, centralized management of group treasury) or financial lease agreements.
- Under the Swiss thin cap guidelines, the maximum indebtedness for companies whose main purpose is a financial business activity is 6/7 of the company’s assets.
- For Australian financial outbound investors (non-authorized deposit-taking institution or non-ADI), the *safe harbor debt level* is modified to permit a higher allowable debt level. Broadly, this calculation is based on a 20:1 debt-to-equity ratio; also, special

¹⁰ Non-debt liabilities typically include provisions for employee entitlements, ordinary trade payables, accruals balances and other non-interest bearing liabilities

rules apply to a corporation that is authorized to carry on a banking business in Australia, based on regulatory requirements (described below in section 4).

3. *The role of non-tax financial regulatory rules*

Only Australia expressly relies on capital adequacy requirements prescribed by the Australian Prudential Regulation Authority in policing banks. None of the remaining five countries explicitly rely on financial regulatory rules to police over-leveraging; however, reference is made to regulatory regimes in Switzerland and Germany.

Although there is no set rule in Switzerland, if the thin cap rules are violated, Swiss tax authorities can grant an exception when it can be demonstrated that the requirements of regulatory capital are met. As noted above, although Germany's general interest expense limitation rule does not take regulatory capital requirements into consideration, the method for allocation of capital between branches and headquarters — which also aims to limit the maximum amount of interest expense deductible in Germany — is based on risk-weighted assets for regulatory purposes.

IV. GENERAL ANTI-AVOIDANCE RULES

Finally, the SIFMA working group looked at whether the tax regimes included any income-based rules designed to protect the domestic tax base (such as debt-to-equity ratio tests, active business income tests, or minimum levels of foreign taxation requirements that could result in current taxation by the home country). The group found that Switzerland is the only one of the six countries that has *not* adopted an income-based anti-avoidance provision. France and Germany exclude passive income unless such income is taxed at a prescribed minimum foreign tax rate (generally, less than 50 percent of the French rate that would apply and less than 25 percent in Germany). Japan's rule is somewhat more complex: The rule applicable to a "Tax Haven Company" applies to income of a more-than 50-percent-owned subsidiary that has a head office in a country where the effective tax rate is 20 percent or less. There is, however, an active business exception that applies where a Tax Haven Company's main business is to actively operate and manage its own business in its own jurisdiction. Both the UK and Australia¹¹ seek to

¹¹Australia's CFC rules are in the process of reform and ongoing consultation is underway – the centerpiece for these reforms is the proposed active business exemption which is designed to ensure only passive income is attributed to Australian resident controllers. The exposure draft legislation was released on 17 February 2011. Given the scale, complexity and importance of these rules, further consultation is underway before it is to be introduced into Parliament. Under the proposed new rules, the existing listed country, active income test, and AFI subsidiary exemptions will be retained. Further, the proposed CFC rules do not attribute tainted service or sales income. Moreover, a CFC grouping rule is incorporated which, broadly, should exclude most CFC to CFC passive income such that only certain non-grouped passive income may be attributable.

identify profits that have been “artificially diverted” from the home country. The UK rules may apply where a company is resident outside of the UK, but is controlled from the UK and subject to a level of tax that is less than 75 percent of the applicable UK rate. The five anti-avoidance regimes operate to impose a current home country tax.

Importantly, France, Germany, Japan, Australia, and the UK provide rules that accommodate financial services:

- **France.** Under one of the several safe harbor provisions in French law, the anti-avoidance rules do not apply if the profits of the foreign entity are derived from an industrial or commercial activity effectively performed in the country of establishment (e.g., banking and insurance services would qualify as commercial activities).
- **Germany.** The German CFC rules do not apply to foreign operations of banking institutions (both CFCs and branches) that have sufficient substance for carrying on banking business in a commercial manner and provided such business is not carried out predominantly (according to the German tax authorities not more than 50 percent) with German resident taxpayers holding ownership interest in such foreign operations or with parties that are related to such German residents.
- **Japan.** Even where the active business exception applies, certain types of passive income derived by a Tax Haven Company could be included in the Japanese parent company’s income (“Passive Income Rule”). There is, however, an exception to the Passive Income Rule for “income derived from fundamental, essential and important activity.” Although there is no specific definition of income that is eligible for this exception, SIFMA understands that interest on bonds derived by banks or securities dealers is likely to be excluded from the definition of passive income.
- **The UK.** The UK CFC rules contain specific provisions for financial services activities. In considering whether a financial service business constitutes an exempt business for UK CFC purposes, there are prescribed thresholds that must be satisfied. Such companies should not carry on investment business and greater than 50 percent of their receipts should be derived from non-connected or associated persons. There are further tests to be satisfied including that not more than 10 percent of gross trading receipts are from UK persons.
- **Australia.** There are special CFC rules relating to Australian financial institution subsidiaries carrying on financial intermediary business. In effect, these special rules can exempt certain income derived from what would usually be classified as tainted assets (such as swap contracts, debentures, trading in loans, bonds, stocks, bills of exchange and promissory notes, *etc.*).

CONCLUSION

SIFMA appreciates the efforts of the Committee in delving into the international tax rules of other countries, in striving to design a tax reform plan that strikes a balance between global competitiveness and preserving the tax base. Our member firms stand ready to assist members of the Committee and their staffs to gain a more detailed understanding of the significance of tax rules relating to interest expense of U.S.-headquartered SIFMA members that are global financial services firms. SIFMA and its members look forward to working with the Committee in developing positive policy options that may impact financial markets, economic growth and job creation.

The Working Group on Intangibles, Statement**WORKING GROUP ON INTANGIBLES**

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STATEMENT OF THE WORKING GROUP ON INTANGIBLES**ON*****INCOME FROM INTANGIBLE PROPERTY THAT IS ESSENTIAL TO THE ACTIVITIES OF A GLOBAL U.S. BUSINESS*****SUBMITTED FOR THE RECORD OF THE HEARING****ON*****“HOW OTHER COUNTRIES HAVE USED TAX REFORM TO HELP THEIR COMPANIES COMPETE IN THE GLOBAL MARKET AND CREATE JOBS”*****BEFORE****THE COMMITTEE ON WAYS AND MEANS****ON****MAY 24, 2011**

Introduction

The Working Group on Intangibles (the “Intangibles Working Group”) welcomes the opportunity to provide comments for the record of the May 24, 2011 Committee on Ways and Means (“Committee”) hearing to “examine international tax rules in various countries with an eye toward identifying best practices that might be applied to international tax reform in the United States.”¹ The Intangibles Working Group is composed of U.S.-based worldwide companies representing a cross-section of industries, including medical device manufacturers, food product companies, consumer nondurable goods companies, pharmaceutical companies, software companies, and information technology companies.

Although the make-up of the Intangibles Working Group is diverse, the member companies generally share several major characteristics – they spend billions of dollars annually on research and development (“R&D”) in the United States, and they deploy cutting edge technologies that are integral to products sold to consumers around the globe. In almost every case, they derive foreign-related income from patents, trademarks, or other intellectual property that has substantial value independent of underlying goods or services (“intangibles”). Moreover, members of the Intangibles Working Group compete throughout the world with foreign-headquartered companies that have limited exposure to the U.S. tax regime and may also benefit from special rules in other countries. Thus, the U.S. tax treatment of foreign source intangibles income is of critical importance to companies in the Intangibles Working Group.

The current U.S. tax rules relating to R&D and the use of intangibles, combined with the U.S. deferral rules, contribute to the creation of high-paying U.S. jobs that result from our

¹ <http://waysandmeans.house.gov> (Hearing Advisory: accessed 18 May 2011).

WORKING GROUP ON INTANGIBLES

companies' successful worldwide operations. Thus, legislative proposals negatively affecting the taxation of intangibles income could have a dramatic impact on both the number and location of R&D jobs currently in the United States as well as the ability of our companies to compete effectively in the global marketplace. Given the focus on "policy choices that maximize competitiveness and job creation,"² we would like to share our preliminary views regarding the implications of four regimes that were designed to provide more competitive rules for intangibles income, namely those in Belgium, Netherlands, Luxembourg, and (most recently) the United Kingdom ("UK"). The treatment of intangibles under these European regimes – all of which have come into effect or been developed in or after 2007 – may provide useful "benchmarks" for U.S. policy makers who seek to reform the U.S. international corporate tax regime in a manner that is consistent with international norms. To summarize our findings, relevant to the Committee's goal of "identifying best practices"³ the European countries we surveyed –

- (1) Provide robust incentives to conduct R&D within their borders; and
- (2) Provide a "carrot" of incentives to retain ownership and exploitation of intangibles in their countries, rather than utilizing a "stick" in the form of punitive taxes to address concerns about the "mobility" of intangibles income.

Discussion

Members of the Intangibles Working Group employ intangibles in *routine* ways as an integral part of their business activities, including manufacturing, R&D, distribution, and the provision of services. The Intangibles Working Group was originally formed in response to revenue-raising proposals to increase the tax burden on certain income from intangibles.⁴ Previously, the Intangibles Working Group submitted a statement for the record of the Committee's July 22, 2010 hearing on transfer pricing, to explain why such proposals would threaten U.S. competitiveness and innovation. Consistent with the Committee's current focus on laying the groundwork for the consideration of comprehensive tax reform, this statement sets forth a conceptual basis for "design elements" that should be a part of any tax reform plan (territorial or otherwise), if the goal is to encourage companies to locate high-value jobs and activity associated with the development, manufacture, and exploitation of intangibles in the United States.

Based on our comparative survey of the selected European regimes, we have developed a general framework for examining tax incentives and tax penalties designed to reward technical innovation, retain or create high-value jobs, and enhance the competitiveness of U.S. companies. Of course, a particular country's treatment of intangibles income should be evaluated in the

² *Id.*

³ *Id.*

⁴ President Obama's FY2011 and FY2012 budgets include novel proposals to end deferral for income from intangibles under circumstances that have yet to be fully defined. As described, the current proposal would impose immediate U.S. tax on the "excess intangible income" from "transactions connected with or benefitting from" intangibles that a "U.S. person transfers...from the United States to a related CFC...if the income is subject to a low foreign effective tax rate." Very generally, "excess" income" would be defined as the excess of gross income from transactions over costs (excluding interest and taxes) plus a percentage mark-up. See General Explanation of the Administration's FY2012 Revenue Proposals, Department of the Treasury (February 2011) 43-44.

WORKING GROUP ON INTANGIBLES

context of other features of the underlying corporate tax system (such as the maximum statutory tax rate and the existence of a dividend exemption system for foreign earnings) or applicable treaties (e.g., because the countries we surveyed are members of the European Union, they were limited in their ability to link incentives to in-country jobs; this would likely not be the case in the United States). Nevertheless, it is possible to discern broad similarities among the four countries that could be used to inform the legislative process in the United States.

- **The Prevalence of R&D Incentives.** As noted above, in addition to a special regime for intangibles income, all four countries provide a variety of R&D incentives such as credits or exemptions to wage withholding for research activity. For example Belgium provides an investment deduction or R&D credit, as well as wage withholding tax exemptions for researchers. In contrast, the temporary nature of the U.S. R&D tax credit detracts from its effectiveness due to the resulting lack of predictability. *To remain competitive internationally, the Intangibles Working Group supports an attractive and permanent R&D credit in the United States.*
- **Use of Tax Regimes to Help Companies Compete Globally.** Precisely because of concerns about the mobility of intangibles, the selected countries embraced incentives designed to encourage their companies to exploit intangibles in the home country. *A preferential regime for intangibles income would move the United States in a similar direction of encouraging companies to retain ownership of intangibles in the United States.*
- **No “Claw Back” of the Tax Benefits of the Preferential Regime.** None of the four countries have adopted or proposes to adopt broad anti-abuse rules that would have the effect of negating the promised benefits. As one example, the UK government considered expanding its controlled foreign corporation (“CFC”) regime to tax intangibles income currently in the case of “excessive profits,”⁵ similar to President Obama’s FY2012 budget proposals to end deferral for “excess intangible income.” We are informed, however, that the March 23, 2011 UK Budget Update reflects a reconsideration of this approach, consistent with the statement that the “aim is to make the CFC regime more competitive while providing adequate protection of the UK corporation tax base. The new regime will... operate in a targeted and more territorial way by bringing within a CFC charge *only* the proportion of overseas profits that have been artificially diverted from the UK” (emphasis added).⁶ *Because the current treatment of intangibles is part and parcel of the deferral rules that have helped U.S. global corporations to remain competitive and preserve high-paying U.S. jobs, an “excess returns” proposal (in present law or a territorial-type system) would have a similar anti-competitive effect.*

⁵ *Corporate Tax Reform: delivering a more competitive system*, page 26, 29 November 2010 (http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfe_reform.pdf : accessed 20 May 2011)

⁶ *Overview of Tax Legislation and Rate*, page 22, 23 March 2011 (<http://www.hmrc.gov.uk/budget2011/overview.htm> : accessed 20 May 2011).

WORKING GROUP ON INTANGIBLES

Members of the Working Group have granted rights in or to intangibles to their related foreign subsidiaries in order to function in global markets and compete against foreign-based multinational corporations. Rights to use intangibles are not granted casually, and the granting of such rights is usually required to facilitate multi-source manufacturing, and to obtain protection under trademark, patent, or other applicable law, quite apart from tax considerations. Furthermore, such grants or transfers must be done in compliance with all applicable laws and regulations, not just U.S. transfer pricing rules. In the case of a global business, rights to intangibles must be granted across the worldwide affiliated group of corporations – with arm's length compensation provided for the functions performed, risks borne, and investments made by each such corporation. These business realities must be given consideration in applying the framework outlined above.

Conclusions

It is vitally important that policy makers seriously consider reforming the U.S. international corporate tax regime in a manner that is consistent with international norms, including the treatment of intangibles income. The transfer and collaborative use of intellectual property are necessary components of modern business practices. These transfers relate both to U.S. developed intellectual property used by foreign affiliates as well as foreign developed intellectual property used by U.S. affiliates. The Intangibles Working Group looks forward to assisting members of the Committee and their staffs to gain a more detailed understanding of the business practices that are necessary for our companies to compete globally, and the tax consequences of these practices. We are hopeful that the Committee will continue its thorough examination of much needed comprehensive reform of the U.S. international tax regime, rather than the development of piecemeal proposals that would produce unintended negative results for U.S. companies, U.S.-based R&D jobs, and ultimately U.S. competitiveness.

