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Hearing on the Current Federal Income Tax
and the Need for Reform

Good morning, Chairman Camp, Ranking Member Levin, and other members of the Committee. Thank you for this opportunity to share my views on tax reform, a critically important issue for the future competitiveness of the American economy. My testimony will focus on a component of the U.S. tax system that is particularly in need of reform: the corporation income tax.

A quarter of a century ago, President Reagan defied all the skeptics and provided the leaderships for a <u>bipartisan</u> overhaul of the tax system that dramatically lowered tax rates and scaled back tax breaks that favored certain groups and activities over others. It was a victory for the public over the special interests.

Twenty-five years later the need for tax reform is greater than ever.

The complexity of the law costs businesses billions of dollars. Families endure endless hours of anxiety and paperwork.

The perception of unfairness—whether due to outright cheating by investors hiding funds on Caribbean islands or to special interests who can lobby their way to lower taxes—is an insult to the majority of taxpayers bearing their fair share.

And on top of all this our tax code is dead weight on the shoulders of the American economy. Its long list of subsidies and handouts defies any notion of a free market. The tax code's interference with the free-market impedes the efficient allocation of capital, hampers productivity growth, and reduces international competitiveness. To promote job creation the

[1] The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

tax code should minimize its role in the economy by rechanneling the revenues devoted to tax breaks into lower rates.

1. Reduction in the Corporate Tax Rate is a Necessity

In recent years the need for a significant reduction in the corporate statutory tax rate has moved from being just another good idea to being an absolute necessity for maintaining international competitiveness. Between 1995 and 2005, foreign statutory corporate tax rates have dropped on average about one percent per year, and since then rates have continued their decline.[2] And just last month, the Japanese government announced its intention to reduce its corporate tax rate by 5 percentage points, effective April 1 of this year.[3] This will leave the United States with the dubious distinction of having the highest statutory corporate tax rate in the world.

A high corporate tax rate is an invitation for a host of troubles. It encourages corporations to issue debt. It encourages corporations to engage in complicated and expensive tax planning. Most of all, it reduces investment and job creation in the United States.[4]

2. Severe Budget Pressures Suggest Revenue-Neutral Corporate Reform

As already noted, base broadening corporate tax reforms are good in and of themselves because they remove market-distorting subsidies from the tax code. In this fiscal environment, base-broadening assumes additional importance.

We are on the road to fiscal catastrophe, and so far practically no action has been taken to remedy the problem. In order to put the nation's finances on a sustainable path—that is, just to get our debt-to-GDP level to stabilize (far short of balancing the budget)—will require annual deficit reductions of approximately $500 billion.[5]

With these enormous and unprecedented budget pressures, it seems reasonable to assume necessary corporate tax cuts must be accompanied by corporate base broadening. This is the view of the White House, as articulated by Treasury Secretary Geithner on January 12: "We are going to take a look at whether we can find political support for a reform of the corporate tax code that would lower rates by broadening the base but not lose revenue on net."[6] Rate

[2] Martin A. Sullivan, "On Corporate Tax Reform, Europe Surpasses the U.S.," *Tax Notes*, May 29, 2006; more recent data is available from the Organization for Economic Cooperation and Development, http://www.oecd.org/document/60/0,3746,en_2649_37427_1942460_1_1_1_37427,00.html.
[3] Martin A. Sullivan, "Japan Cuts Corporate Rate, Puts Austerity on Hold," *Tax Notes*, Jan. 3, 2010.
[4] Martin A. Sullivan, "Beyond the Conventional Wisdom: Rate Cuts Beat Expensing," *Tax Notes*, Jan. 28, 2008.
[5] Martin A. Sullivan, "Deficit Commission: How Big Will the Tax Hikes Be?" *Tax Notes*, Mar.1, 2010. New estimates from the Congressional Budget Office imply an even larger amount of deficit reduction will be required to put the federal debt on a sustainable path. See, CBO, "The Long-Term Budget Outlook," June 2010, p. 14. Revised deficit projections will be released by the CBO on January 26, 2011.
[6] Eric Kroh, Drew Pierson, and Meg Shreve, "White House Begins Outreach Effort on Corporate Tax Reform," *Tax Notes*, Jan.17, 2011.

reductions in the United Kingdom, Germany, and Japan have been accompanied by significant expansions of the corporate tax base.[7]

3. The Current Corporate Tax Favors Some Business Sectors over Others

The essence of an efficient and competitive tax system is a level playing field. Government should not attempt to outguess the market and pick winners and losers. Unfortunately, there is a wide disparity in the tax treatment of businesses under current law.

The table below provides some examples of this disparity. While many corporations have effective tax rates approximately equal to the 35 percent statutory rate, other corporations have effective rates in the low twenties, the teens, and even the single digits. The major reason for these low effective tax rates is the ability of some corporations to shift a significant portion of their profits into low-tax jurisdictions.[8]

Winners and Losers Under Current Code

	Effective Tax Rate		Effective Tax Rate
Cisco Systems	19.8%	Aetna	34.6%
General Electric	3.6%	CVS Caremark	38.8%
Hewlett Packard	20.0%	Disney	36.5%
Johnson & Johnson	22.0%	Home Depot	35.4%
Medtronic	19.7%	Target	37.2%
Merck	12.5%	United Health Group	35.4%
Pfizer	17.1%	Wal-Mart	33.6%

Source: Most recent company annual reports. Tax rates shown here are average of three years presented in most recent report.

As the table shows, low effective tax rates are common in industries like pharmaceuticals and computer equipment where it is easy to shift technology and manufacturing to low-tax jurisdictions. In industries where customer markets and the provision of services are largely domestic, the opportunities for reducing taxes through cross-border profit shifting are limited.

4. International Tax Rules Favor Foreign Over Domestic Job Creation

Under current law, if an American corporation opens a factory in Indiana, the profits of that factory are subject to the 35 percent U.S. corporate tax rate. If the same corporation instead opens a similar factory in Ireland, the profits from that factory are subject to a 12.5 percent tax rate. If that factory generates a profit of $100, the choice is between an after-tax profit of $65 in the United States and $87.50 in Ireland. Obviously, U.S. tax law provides a large tax advantage for building and moving factories to low-tax countries.

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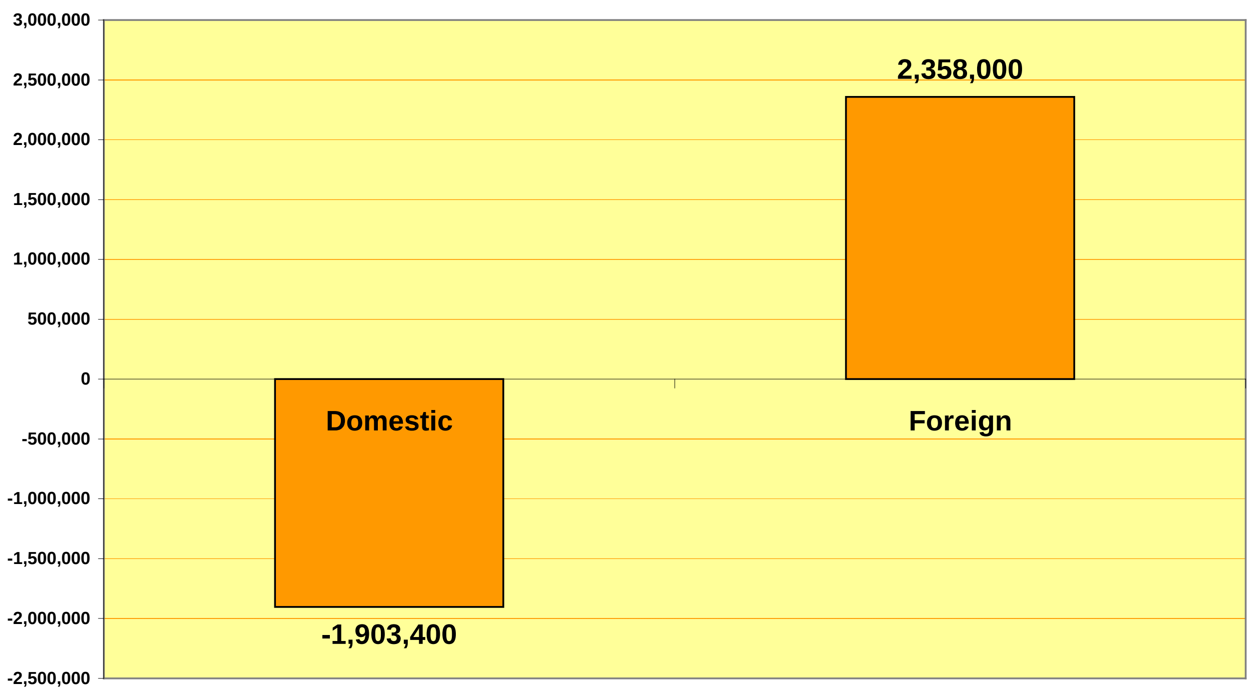
[7] For European examples, see Martin A., Sullivan, "A New Era in Corporate Taxation," Testimony before the Committee on Finance, United States Senate, June 13, 2006. For a description of corporate tax reform in Japan, see PricewaterhouseCoopers, "Japan Tax Update," special edition, issue 56, December 2010.

[8] Martin A. Sullivan, "Why Reported Effective Corporate Tax Rates Are Falling," *Tax Notes*, Mar. 3, 2008.

In their advocacy for relaxation of U.S. tax rules, U.S. multinational corporations like to ignore the possibility that foreign investment (provided incentive by U.S. tax laws) can *substitute* for U.S investment. They focus instead on the idea that foreign investment can *complement* U.S. investment. In other words, it is in the best interest of the United States to increase *foreign* investment and job creation because this will increase *U.S.* investment and job creation.

No doubt foreign investment by U.S. multinational corporations has both substitution and complementary effects on U.S. investment. Intuitively, you can think about substitution occurring when a U.S. multinational decides to open a factory abroad rather than in America. Complementary effects are likely to occur when a multinational opens a distribution and marketing affiliate that increases worldwide sales, which in turn increases demand for U.S. research and development and U.S. headquarters services.

U.S. Multinationals Job Creation, 1999-2008



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

The two effects are not mutually exclusive. They offset each other. One reduces U.S. job creation. The other increases it. Data from the U.S. Department of Commerce (in the figure above) shows that since 1999 U.S. multinational corporations have reduced domestic employment by 1.9 million while increasing foreign employment by 2.4 million. Whatever the positive effects of foreign operations may be on domestic employment, they have not offset the job losses. U.S. multinational corporations are not net domestic job creators.[9]

5. Profit Shifting to Tax Havens Results in Large Revenue Loss

Data from a variety of sources indicate inappropriate profit shifting occurring on a large scale. By "inappropriate" I mean the perfectly legal but economically indefensible assignment of profits to subsidiaries in low-tax jurisdictions.

The table below presents the latest data on the profitability of affiliates of U.S. multinational corporations in five low-tax countries. In all these jurisdictions, the average effective tax rate of U.S. affiliates was below 10 percent. Although these are all small jurisdictions (with their economies equal to only about 2 percent of the world's non-U.S. gross domestic product), they together account for 21 percent of foreign profits of U.S. multinationals. There is no perfect way to measure profitability, but by almost every measure these five tax havens have extraordinarily high rates of profit. These data strongly suggest U.S. multinationals are readily able to shift profits into tax havens and thereby significantly reduce taxes properly owed to the United States and other industrialized nations.[10]

Profits and Profitability of Foreign Affiliates of U.S. Multinationals in 2008

	Before-tax Profits (millions)	Effective Tax Rate	Profit as % of Sales	Profit as % of Property	Profit as a % Employee Compensation	Profit per Employee
Ireland	**$ 46,337**	**7.3%**	**18.6%**	**117%**	**708%**	**$ 520,640**
Switzerland	**$ 16,352**	**11.5%**	**5.9%**	**141%**	**189%**	**$ 200,638**
Bermuda	**$ 8,354**	**4.8%**	**14.3%**	**132%**	**2,234%**	**$ 2,610,625**
Barbados	**$ 4,263**	**6.9%**	**38.0%**	**251%**	**11,218%**	**$ 4,263,000**
Singapore	**$ 12,255**	**8.1%**	**4.3%**	**84%**	**227%**	**$ 103,157**
Five Tax Haven Total	$ 87,561	7.9%	10.0%	119%	417%	$ 298,334
Worldwide Total	$ 408,720	35.2%	7.9%	42%	93%	$ 40,372

Source: Author's calculations using latest data from the Bureau of Economic Analysis of the U.S. Department of Commerce. The BEA data do not include banks.

Over the last decade, the transfer pricing problem has gone from bad to worse. From 1999 through 2007, foreign profits of U.S. multinationals have increased by 163 percent, while over the same period, traditional indicators of economic activity have increased on average by only

[9] Advocates for multinational corporations often cite a study by Mihir Desai, Fritz Foley, and James Hines ("Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*) and work by Matthew Slaughter ("How to Destroy American Jobs," *Wall Street Journal*, Feb. 3, 2010) as evidence that U.S. multinationals promote domestic job creation. But both lines of this research suffer from shortcomings. See Martin A. Sullivan, "Will Obama's International Proposals Kill U.S. Jobs?" *Tax Notes*, June 1, 2009 and Martin A. Sullivan, "Jobs and International Tax Rules," *Tax Notes*, Feb. 8, 2010.

[10] These finding are consistent with other studies that find an inverse relationship between the profitability of foreign subsidiaries and foreign tax rates. See, Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, pp. 55-61.

97 percent. This excessive growth of foreign profits represents an annual revenue loss of $28 billion over and above the revenue loss if transfer pricing rules were as effective as they were in 1999.[11] This is an estimate of the minimum annual revenue loss from inappropriate transfer pricing and income shifting.[12]

6. Profit Shifting Turbo-charges the Incentive for Foreign Job Creation

But the growing problem of profit shifting to low-tax countries is about more than lost revenue. It is about turbo-charging the incentive to move operations offshore. The ease with which U.S. corporations can move profits makes it vitally important for U.S. corporations to invest outside of the United States.

The simple example presented earlier—comparing the U.S. 35 percent rate with the Irish 12.5 percent rate—is unrealistic and grossly understates the tax advantages of foreign over domestic investment. That's because it does not take into account the enormous tax benefits derived from profit shifting through transfer pricing.

Not only can investment reduce tax on Irish profits, it reduces on taxes properly attributable to profits from high-tax countries, including the United States.

Building on the simple example described before, let's suppose that for a nominal fee the U.S. parent company allows the Irish subsidiary to use valuable marketing and manufacturing intangibles. Without access to these intangibles the Irish subsidiary would only have $100 of profits. That $100 is the true economic income attributable to the activities in Ireland. Access to the parent company's intangibles, however, allows the Irish subsidiary to book $300 of profit. The Irish subsidiary should be paying the U.S. parent $200 in royalties (or its equivalent), but because of lax transfer pricing rules it does not.

With a 12.5 percent tax rate, Irish tax liability on $300 of reported profits is $37.50. The shift of $200 of profits out of the United States reduces U.S. taxes by $70. The total tax effect of the investment in Ireland is an increase in Irish tax of $37.50 and a reduction in U.S. tax of $70. The net tax effect of investment in Ireland is a *reduction* in tax of $32.50.

Given the $100 of true economic profit in Ireland, the effective tax rate is *negative* 32.5 percent. Proponents of capital export neutrality and a worldwide system would argue the proper tax rate in this example is 35 percent (the U.S. rate). Proponents of capital import neutrality and a territorial system would argue the proper rate of tax in this example is 12.5 percent (the Irish rate). There is no principle of international taxation that can condone negative effective tax rates on foreign investment.

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[11] Martin A. Sullivan, "Transfer Pricing Costs U.S. at Least $28 Billion," *Tax Notes*, Mar.22, 2010.

[12] The total annual U.S. revenue loss is probably significantly larger than $28 billion because (1) the data used in this estimate exclude financial corporations and (2) this estimate only accounts for increased revenue loss since 1999, and by all accounts there was already a significant transfer pricing problem in 1999. On this last point see, for example, James Hines and Eric Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics*, February 1994.

Because of legal transfer pricing practices, the U.S. Treasury is providing billions of dollars of subsidies for U.S. companies to invest in Ireland and other tax havens.[13]

Irrespective of your views about whether the United State should move to a territorial system or not, we should all be able to agree that the inefficiency of subsidies, provided through aggressive transfer pricing, is a drag on economic growth and job creation.

7. Multinational Competiveness is not U.S. Competitiveness

Multinational corporations are important to the U.S. economy. They account for the bulk of our private-sector R&D. They are export-intensive—accounting for a proportionately larger share of exports than the rest of the economy. Of course, we want our multinationals to improve their competitiveness.

But support for U.S. multinational businesses should not come at the expense of other sectors. Yes, U.S. multinationals create jobs. But so do purely domestic corporations. So do small businesses. And so also do foreign-headquartered companies that invest in the United States. We must remember that multinationals' competitiveness and overall US competitiveness are not always the same thing. Promoting overall—or "standard of living competitiveness," as the Joint Committee on Taxation labels it[14]—is the superior policy objective.

Favorable treatment of one sector over another generally hurts overall competitiveness because the free market allocation of capital is distorted.

To promote economic growth and maximum job creation all corporate business should be taxed evenly. Low rates of corporate tax are desirable for all these businesses. Any relaxation of current international rules would only increase disproportionate benefits for multinationals versus other businesses. To do this in the fairest and most efficient manner possible, we should minimize the enormous tax breaks for offshore job creation made possible by aggressive transfer pricing and use the revenue gains to lower corporate tax rates for all U.S. corporations.

8. Conclusion: Base-Broadening Should Begin with Reform of International Tax Rules

When the Bush Treasury Department listed ways to pay for lower corporate tax rates, the three largest revenue raisers were: (1) changes to the depreciation rules, (2) repeal of the section 199 domestic production credit, and (3) repeal of the research credit.[15] These are direct incentives for domestic job creation. They are only available for business activity in the

[13] Martin A. Sullivan, "U.S. Serves as Silent Partner in Ireland Bailout," *Tax Notes*, Dec. 6, 2010.
[14] Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS-6-91, May 30, 1991.
[15] 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).

United States. In light of the current 9.4 percent unemployment rate, **when we start broadening the tax base to pay for corporate rate reduction, we should cut incentives for foreign investment before we cut incentives for domestic investment.** For obvious reasons, when Congress designs tax incentives it insists that they only be available for domestic activity. As so the tax benefits of accelerated depreciation and tax credits are only available for investment and job creation inside U.S. borders. Before we reduce depreciation allowances, or the domestic production credit, or the research credit, we should limit the ability of corporations to shift profits to low-tax countries and to take advantage of enormous incentives to create jobs offshore.

Whatever direction corporate reform takes—whether the United States moves to a territorial system or retains the current worldwide system--Congress must consider tougher measures to prevent transfer pricing abuse. Current statutes and regulations enshrine the arm's-length standard. This standard gives primacy to the often futile search for comparable, unrelated-party transactions in the hope of using those transactions to determine the terms for related-party transactions.

The arm's-length method is seriously flawed in both theory and practice. The theoretical problem is that because of synergies within large corporations—what economists call "economies of scope"—the economic relationship between entities within a corporate group are not the same as those between unrelated parties.[16] The practical problem is the lack of truly comparable unrelated transactions that can be used to apply the arm's-length method to related-party transactions.[17] Modifying the arm's-length standard will not get the job done.[18]

The major alternative to the arm's-length method for allocating income to locations is formulary apportionment. The major problem with a pure formulary approach is international coordination (including a lot of renegotiation of existing tax treaties). The major benefit would be the elimination of profit accumulation in tax havens with little or no real economic activity. Although proponents of the arm's-length method hate to admit it, there are some formulary elements employed in current law.[19] Profit-split methods widely used for allocating income from intangibles are a crude version of a formulary method.

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[16] Synergies in production, distribution, and risk-bearing are an economic explanation of why multinationals exist instead of a myriad of smaller companies buying and selling specialized products and services from each other.

[17] The only good opportunity for using comparables for determining royalties for related-party intangibles is when the multinational has licensed the same intangible to an unrelated party in another geographic market. But even under these circumstances, the degree of comparability can be unsatisfactory because of market differences. For example, the per-unit profitability of a rice cooker employing a new technology may be different in Asia than in Europe.

[18] "To date, the JCT Staff is unaware of any comprehensive proposal to modify the arm's-length pricing rules in a manner that would ensure their effectiveness." (Joint Committee on Taxation, "Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment," June 25, 2008, JCS-55-08.)

[19] Martin A. Sullivan, "A Middle Path between the Arm's Length and Formulary Methods," *Tax Notes*, Jan. 18, 2010; and Lee. A. Sheppard, "Stress Testing Transfer Pricing," *Tax Notes International*, Mar. 16, 2009,

Another method of attacking the transfer pricing problem would be to reduce the availability of deferral in situations where transfer pricing abuse is likely. Around the world and traditionally in the United States, anti-deferral rules (usually referred to as “Subpart F rules” in the United States or “controlled foreign corporation rules” in the rest of the world) are widely-used as a backstop to the transfer pricing rules.

Other major industrialized countries, most of whom have exemption systems, have anti-abuse rules that revoke the exemption privilege not only for passive income but also for active income where there is potential for transfer pricing abuse that threatens the domestic tax base.[20] The rules vary widely and are highly complex. These rules struggle to maintain a balance between competitiveness (by providing a full exemption for properly measured foreign source income) and preventing tax avoidance (by preventing shifting of domestic income to tax havens).

In trying to identify situations where transfer pricing abuse is likely, these rules look at a number of factors. High on the list is the favorability of the tax system of the jurisdiction in which the foreign subsidiary operates. Some countries form “white lists” of jurisdictions that have sufficiently high levels of taxation or have treaties with the home country. Subsidiaries operating in white list countries automatically qualify for exemption or face less stringent anti-avoidance rules. Other countries have created “black lists” of tax havens where exemption is not permitted or is much more difficult to obtain. Still another method is to determine the effective tax rate of a subsidiary and only allow exemption if it exceeds some threshold. In addition to low tax rates, other factors that could trigger anti-avoidance treatment are lack of commercial activity or lack of local management and control in a subsidiary in a low-tax jurisdiction.

In its FY2011 budget, the Obama Administration proposed creating a new category of subpart F income. Under the proposal, the profits subject to Subpart F inclusion would be (1) from an intangible, (2) from a subsidiary paying low foreign taxes (suggested by the Treasury to be less than 10 percent), *and* (3) earning an excessive return (suggested by Treasury to be above 30 percent). All three of these characteristics are commonly found in inappropriate transfer pricing. **The Obama proposal is in line with the well-established practice of using CFC/Subpart F rules as a backstop to transfer pricing rules.** As such, if it is properly

[20] There is no disagreement about the need for passive income to be subject to anti-deferral rules. (Otherwise, U.S. taxpayers could shift assets to tax haven corporations and pay no tax on income from those assets.) The issue is what, if any, foreign active business income should be subject to immediate U.S. tax. In 1962, Congress recognized that certain situations were highly susceptible to transfer pricing abuse. At that time, when most real business activities of U.S. multinationals took place in high-tax countries, the establishment of “base companies” in low-tax jurisdictions and the transfer of profits through related-party transactions to these base companies provided significant tax savings. To take the tax benefit out of these transactions, Congress subjected base company income to immediate taxation under Subpart F. (These rules are now largely obsolete because of “check-the-box” rules.)

designed, it would be an important additional tool for IRS efforts to combat transfer pricing abuse.[21]

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Mr. Chairman, thank you for the opportunity to share my views.

[21] The administration's proposal is probably too cautious. It targets the low hanging fruit (i.e., profits that are from low-tax countries *and* are from intangibles *and* are "excessive.") One simpler alternative is a minimum tax on foreign earnings. (Martin A. Sullivan, "Should the U.S. Limit 'Excessive' Returns in Low-Tax Countries?" *Tax Notes*, Mar. 15, 2010) Unlike the Obama proposal, all suspect earnings would be subject to a new 10 percent minimum tax (instead of the 35 percent statutory rate). While the penalty rate is lower, the net is cast wider than under the Obama plan. Under the proposed minimum tax, there would be no difference between the treatment of intangibles and other types of income (an often impossible distinction to make). And there would be no need for an arbitrary determination of "excessive profits." Under this plan, all foreign income would be subject to at least a 10 percent tax. If the foreign rate is less than 10 percent, the new U.S. tax would make up the difference.