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THE U.S. TAX CODE:
Love It, Leave It, or Reform It!

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On July 22, 2014, the Senate Finance Committee held a hearing titled, "The U.S. Tax Code: Love It, Leave It, or Reform It!" The general topic of the hearing was international taxation, with a sharp focus on recent and possible future corporate inversion transactions. The hearing also addressed a variety of issues, including the high U.S. corporate tax rate, the potential benefits of a territorial tax system, and the impact that failing to reform the Internal Revenue Code ("IRC" or "Code") would have on the U.S. economy. Witnesses also discussed the Organisation for Economic Co-operation and Development's ("OECD") base erosion and profit-shifting ("BEPS") project, aimed at curbing multinational corporate tax avoidance.

Background

The US corporate income tax rate of 35 percent is one of the highest in the world, and the United States is the only G-7 country that does not have a territorial tax system for multinational businesses based in the country. While these features have been a major focus in the development of comprehensive tax reform proposals, they have also been cited as providing significant incentives for the recent wave of corporate inversions, whereby a U.S. corporation relocates its headquarters abroad. The Obama Administration and many Congressional Democrats have called for an immediate ban on inversions, and some have introduced legislation to achieve this result. Republican tax-writers have opposed legislation of the type proffered to date and have maintained that only comprehensive tax reform that lowers rates, adopts a territorial system, and modernizes the tax Code will ultimately curb inversions. However, following the recent string of inversion announcements, some Republicans may have begun to refine their position.

Current Framework & Recent Proposals

In 2004, following an extended debate of several years on inversions, section 7874 of the IRC was enacted to make it more difficult for companies to avoid U.S. tax treatment on their worldwide income. At the time, a number of companies were moving their headquarters to low-tax jurisdictions such as Bermuda or the Cayman Islands, with little or no business purpose aside from tax considerations. In response to this phenomenon, under IRC section 7874, inverted companies are treated as US companies for tax purposes if: (1) substantially all of the assets of a domestic corporation are acquired by a foreign acquiring corporation; (2) the historical owners of the domestic corporation retain a sufficient ownership interest in the foreign acquiring corporation; and (3) the foreign acquiring corporation, together with the affiliated group that includes the foreign acquiring corporation, does not conduct substantial business activities in the country in which it is created or organized.

IRC section 7874 sets an 80-percent test for purposes of measuring continuity of ownership – if the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80 percent or more (by vote or value), the new foreign parent corporation is treated as a domestic corporation for all US tax purposes. In addition, if the continuing US shareholder ownership is at least 60 percent but less than 80 percent, the foreign status of the acquiring corporation is respected but certain other adverse tax consequences apply (the "60-percent test").

Earlier this year, in its FY2015 budget request, the Obama Administration proposed replacing the 80-percent test with a greater than 50-percent test and eliminating the 60-percent test. The Administration's proposal also includes a rule that, regardless of the level of shareholder continuity, a transaction will be considered an inversion if the affiliated group that includes the foreign corporation has substantial business activities in the United States, and the foreign corporation is primarily managed and controlled in the United States. Finally, the Administration's proposal provides that an inversion can occur if there is an acquisition either of substantially all of the assets of a domestic partnership or of substantially all of the assets of a trade or business of a domestic partnership.

Over the last several months, as more inversion acquisitions have been announced, lawmakers have proposed various legislative solutions to the matter. Notably, Senator Carl Levin (D-MI), a frequent critic of US tax policy and the tax planning employed by US-based multinationals, along with Representative Sandy Levin (D-MI), Ranking Member of the House Ways and Means Committee, have introduced companion bills that would closely follow the Obama Administration's anti-inversion proposal (outlined above). The legislation also provides that the merged company will continue to be treated as a domestic corporation for tax purposes if management and control of the merged company remains in the United States and either 25 percent of its employees, sales, or assets are also located in the United States. Senator Levin's legislation would also function as a two-year moratorium on inverted companies that do not meet these stricter tests, providing Congress with time to consider a long-term solution as part of comprehensive tax reform. While the Administration remained silent for a time, on July 15, 2014, U.S. Treasury Secretary Jack Lew sent a strongly worded letter to leaders of the Congressional tax-writing committees calling for a "new sense of economic patriotism" and urging lawmakers to take action to curb corporate tax inversions by closing "the inversion loophole."

Numerous Members outside of the tax-writing Committees have weighed in as well, turning to the annual appropriations process as a means to affect tax policy. Pending appropriations bills in both the House and Senate contain provisions aimed at curbing corporate inversions. For example, the House recently adopted Representatives Rosa DeLauro (D-CT) and Lloyd Doggett's (D-TX) amendment to the Financial Services and General Government Appropriations Act of 2015, which would prohibit any federal government entity from awarding contracts to companies that have reincorporated in the Cayman Islands or Bermuda. Representative DeLauro, who has included identical amendments within the FY2015 Transportation, Housing, and Urban Development Appropriations bill; the FY2015 Energy and Water Appropriations bill; and the FY2015 Department of Defense Appropriations bill, has recently stated that future amendments may be expanded to sweep in further jurisdictions, including Ireland. Along those lines, on the Senate side, the Department of Defense Appropriations Act of 2015 contains a provision authored by Subcommittee Chairman Senator Dick Durbin (D-IL), which greatly broadens the definition of what qualifies as an inverted corporation for purposes of defense contracting and prohibits such corporations from receiving any funding under the bill. Additionally, Finance Committee Chairman Ron Wyden (D-OR) announced prior to the hearing that his Committee will continue to "look at the short-term and medium approaches [to corporate inversions], to try to make them dovetail with comprehensive tax reform."

However, several notable lawmakers are not in favor of standalone inversion legislation. For example, House Ways and Means Committee Chairman Dave Camp (R-MI) has argued that anti-inversion legislation should not be viewed as a solution and, instead, continues to focus his efforts on comprehensive reform. On the Senate side, Finance Committee Ranking Member Orrin Hatch (R-UT) has suggested that "we can find alternatives that could easily be enacted and are less punitive and restrictive to businesses than those outlined" by the Obama Administration. Nevertheless, Ranking Member Hatch also stated that "there may be steps Congress can take, short of comprehensive tax reform, to address corporate inversions, and related issues," potentially opening the door to negotiations on a short-term solution to curbing corporate inversions.

It is against this backdrop that Chairman Wyden convened the hearing.

The testifying witnesses were:

- Mr. Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of the Treasury, Washington, DC
- Mr. Pascal Saint-Amans, Director, Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development (OECD), Paris, France
- Dr. Mihir A. Desai, Mizuho Financial Group Professor of Finance & Professor of Law, Harvard University, Cambridge, MA
- Dr. Peter R. Merrill, Director, National Economics and Statistics Group, PricewaterhouseCoopers, Washington, DC
- Dr. Leslie Robinson, Associate Professor of Business Administration, Tuck School of Business, Dartmouth College, Hanover, NH
- Mr. Allan Sloan, Senior Editor at Large, Fortune, New York, NY

Opening Remarks

Chairman Ron Wyden (D-OR) began by suggesting that the tax Code is "infected with the chronic diseases of loopholes and inefficiency," which "are a significant drag on the economy and are harming U.S. competitiveness." Chairman Wyden focused his remarks mostly on inversions, suggesting that many companies have the "do inversions now" mentality. Noting that the tax Code is an "uncompetitive mess" and costs the nation billions of dollars each year, he urged the Committee to respond on a bipartisan basis and work to immediately "cool the inversion fever," while using the time resulting from these immediate steps to implement comprehensive tax reform. Chairman Wyden argued that the "feeding frenzy" of inversions should cause concern and questioned how many more inversions the nation can endure.

Ranking Member Orrin Hatch (R-UT) indicated that the goal of comprehensive tax reform should be to make the tax Code more competitive for businesses. Additionally, he cautioned that the United States should not "rush into" the BEPS proposal, suggesting that it could result in increased taxes. However, Ranking Member Hatch focused the majority of his remarks on corporate inversions. According to Ranking Member Hatch, lawmakers should be focused on reducing the corporate tax rate and making the international tax system more competitive. He also stated that the majority of current proposals on inversions are "punitive" and would "build walls around U.S. corporations to keep them from inverting." Nevertheless, Ranking Member Hatch again acknowledged being open to taking short-term action to address inversions. After noting that he does not support any of the legislative options that have been proposed in recent weeks, Ranking Member Hatch stipulated that he would support a proposal that: (1) is not retroactive or punitive; (2) is revenue neutral; (3) moves away from the territorial tax system; and (4) does not impede progress toward implementing comprehensive tax reform.

Witness Statements

Mr. Robert B. Stack began by explaining that, in the Treasury's view, the BEPS project is necessary to address the interaction of various countries' rules for taxing cross-border income. According to Mr. Stack, "The United States has a great deal at stake in the BEPS project and a strong interest in its success. …Our active participation is crucial to protecting our own tax base from stripping by multinational companies, much of which occurs as a result of exploiting differences in national regimes." However, he also underscored the need to preserve the United States' national interest in working on the BEPS project, particularly in the areas of transfer pricing, country-by-country reporting by multinationals of income and tax information, and digital businesses. Additionally, he stated that "we should reform our business tax system by reducing the rate and broadening the base…[b]ut it would only be a start, because even with lower rates U.S. multinationals would continue to aggressively seek ways to lower their tax bills by shifting income out of the United States." To address this issue, Mr. Stack focused on examining interest deductibility and limiting the deduction of interest expenses of U.S. multinationals related to deferred foreign subsidiary income. He also addressed the importance of broadening the scope of the anti-inversion statute as proposed in the Administration's FY2015 budget request, including a retroactive date of May 2014.

Mr. Pascal Saint-Amans likewise focused his remarks on the BEPS Action Plan, which has been fully endorsed by G-20 finance ministers and leaders. Mr. Amans first suggested that countries should favor a broad base, with lower corporate income tax rates. He then explained that current international tax rules have failed to keep pace with economic developments and "have begun to show weaknesses." Highlighting the lack of coherence in international tax rules, Mr. Saint-Amans stated that while international tax standards are intended to eliminate double taxation, they more often facilitate double non-taxation, which stems from the "gaps and frictions in the interaction of different tax systems." He then noted that as a result of growing concern over BEPS, many countries have begun to consider taking action to protect against base erosion. However, he rejected such uncoordinated, unilateral action. Instead, Mr. Saint-Amans argued that the BEPS Action Plan provides a "principled, holistic approach to addressing BEPS" by not only fusing on closing gaps, but also on improving dispute resolution. According to Mr. Saint- Amans, lawmakers are now faced with "a unique opportunity to modernize global standards, restore their coherence, and renew worldwide commitment to principled, consensus-based rules."

Dr. Mihir A. Desai began by suggesting that the recent wave of corporate inversions highlights the increasing costs of employing a worldwide tax regime and a high corporate tax rate. However, Dr. Desai emphasized that these transactions are merely a manifestation of the problems created by the tax Code. In addition to corporate inversions, Dr. Desai highlighted that these problems are also impacting: (1) incorporation decisions by entrepreneurs that anticipate the burdens of being a U.S. corporation; (2) merger patterns that reflect the "penalties" of being domiciled in the U.S and the importance of offshore cash; (3) investment patterns by U.S. and foreign companies; and (4) profit-shifting activities that are not "value-creating." He also suggested that problems stemming from the tax Code have had a negative impact on the U.S. labor force. To address these problems, Dr. Desai argued that reforms should particularly target improving American wages. Further, he stated that tax reform should address both the growing prominence of non-C corporate business income, as well as the disconnect between profits reported to capital markets and to tax authorities. Dr. Desai then provided a "blueprint" for tax reform, which he believes should include: (1) moving to a less complex, territorial regime; (2) a considerably lower tax rate in the range of 18-20 percent; (3) better alignment of book and tax reporting of corporate profits; and (4) some taxation of non-C corporation business income. He concluded by suggesting that legislation narrowly aimed at preventing inversions is likely to be counterproductive.

Dr. Peter R. Merrill opened by providing an overview of U.S. taxation of corporate foreign source income, focusing on the United States' worldwide system of taxation, along with deferrals and mitigation of double taxation. Dr. Merrill also highlighted the disadvantages associated with the high US corporate income tax rate, suggesting that it: (1) discourages both U.S. and foreign companies from locating their most profitable assets and operations inside the United States; (2) encourages both US and foreign companies to locate their borrowing in the United States; and (3) discourages US multinationals from remitting foreign profits to the United States. He then highlighted recent reforms in the United Kingdom, Japan, and New Zealand as models for corporate tax reform in the United States. Moreover, he suggested that the combination of the high US corporate tax rate, along with its worldwide tax regime, places the US at a disadvantage when corporations are choosing where to locate their headquarters. As such, Dr. Merrill suggested that "[r]eform of the US tax system to bring it more in line with international norms would enhance the ability of US multinationals to continue to compete and succeed in global markets."

Dr. Leslie Robinson first asserted that "the international system is one of the most technically complex areas of the US tax code but raises little revenue." Dr. Robinson then refuted various assumptions often made about international corporate taxation, specifically suggesting that there is no evidence that US multinational corporations face greater tax burdens as a consequence of how foreign profits are taxed, relative to their competitors. She also suggested that the significant number of recent inversions by US companies likely signals the necessity of tax reform. According to Dr. Robinson, "the international taxation can be adequately reformed…through a careful combination of base broadening and lower rates." Additionally, she highlighted the following issues to be considered in conjunction with tax reform: (1) revenue and rate estimates of various reform options should take into account the potential increase in repatriations attributable to changes in financial reporting costs; (2) any constraints on shifting income posed by the decision not to adopt International Financial Reporting Standards ("IFRS") in the United States should be considered when evaluating the extent of income shifting that might occur under a new tax system; (3) tax policy makers should consider any role of accounting disclosures in evaluating behavioral responses to various reform options; and (4) tax policy makers should consider tax disclosure requirements as additional policy measures to aid in the enforcement of tax policy.

Mr. Allan Sloan focused his remarks on corporate inversions, providing a brief history of "tax-dodging games," including Morris Trusts, Cash-Rich Morris Trusts, Reverse Morris Trusts, Split-Offs, and Cash-Rich Split-Offs. However, he emphasized that these previous tactics differ from the current trend of corporate inversions, as they do not "involve a company renouncing its corporate citizenship to save money, but expecting to be treated as if it were a regular, legitimate American company." According to Mr. Sloan, "[I]nversions are a symptom of the underlying disease, which is the tax code." Mr. Sloan emphasized that "you've got an emergency here" and urged lawmakers to take immediate steps to stop inversions.

Discussion

Corporate Inversions and Comprehensive Tax Reform. Chairman Wyden emphasized that comprehensive tax reform is unlikely to pass this year and questioned the wisdom of waiting to address the inversion epidemic. Mr. Stack suggested that it would be a mistake to wait for comprehensive tax reform to address the issue, highlighting that inversions do not only lead to a "one year hit" on the US economy, but in fact strip the tax base over the long-term. Other witnesses generally agreed that there is an immediate need to address inversions, but most favored a short-term fix with an eye toward comprehensive tax reform. Chairman Wyden again emphasized that inversions are moving rapidly and that failing to take action soon "is a prescription for real chaos." Senator Charles Schumer (D-NY) concurred, urging the Committee not to wait for comprehensive tax reform before addressing the inversion issue, as waiting will be a "green light to allow many more inversions to occur."

Options to Address Inversions. In speaking about the impact that corporate inversions have on the US economy, Senator Schumer argued that inversions: (1) exempt corporations from paying US taxes on their international operations; and (2) allow corporations to avoid paying US taxes on businesses that remain in the United States by using the US subsidiary to take advantage of the interest expense deduction. As such, Senator Schumer took a hardline on the issue, advocating that inverted corporations not be able to take advantage of the interest expense deduction and suggesting that Congress take "prospective policy action" to counter past and future inversions. Mr. Stack agreed, noting that inverted corporations should not be allowed to "continue to strip the US tax base" by using this deduction. Later, Mr. Stack also mentioned that the Treasury has begun work on its report regarding how to best address corporate inversion transactions, although he was unable to estimate when the report would be completed.

Further, Senator Schumer voiced support for Senator Carl Levin's (D-MI) proposal to curb inversions, highlighting in particular the importance of the proposal's two-year moratorium on inversions. However, Senator Schumer also raised concerns about the proposal's provision requiring a company to pay US taxes if management and control of the company remains in the United States. Senator Schumer's comments suggest that Democrats have yet to unify around one specific proposal.

Senator Sherrod Brown (D-OH) questioned how to create a regime that permits legitimate transactions, while at the same time preventing "arbitrage-driven inversions." According to Mr. Stack, the focus should be on strengthening the US interest-stripping rules and limiting the ability of US subsidiaries of a foreign multinational corporation to deduct a disproportionate amount of global interest expense in the United States. Senator Brown responded that Congress should "do something narrowly now."

In referencing her bill, the "Bring Jobs Home Act," Senator Debbie Stabenow (D-MI) emphasized that tax reform, particularly with regard to curbing inversions, should not be a partisan issue. Senator Stabenow referenced those companies that want to access US infrastructure but do not want to contribute through paying taxes, which she suggested would "create a race to the bottom." According to Mr. Stack, there will always be countries with lower corporate tax rates, thus the focus should be not only on lowering the US corporate tax rate, but also on broadening the base and creating equality by ensuring that all companies are able to take advantage of a lower effective tax rate in a fair way.

Additionally, Chairman Wyden suggested that repealing deferrals would "go a long way to corporate tax simplification." Dr. Robinson concurred, explaining that she favors eliminating deferrals and lowering the corporate tax rate over implementing a territorial tax system.

On the Republican side, Senator Rob Portman (R-OH) stated that he would prefer an approach that "encourages solving the problem rather than dealing with the symptom." According to Senator Portman, the fundamental problem leading to inversions is the tax Code. He suggested that, under current law, it makes more economic sense to be a foreign corporation with access to a territorial system and a lower corporate tax rate. As such, he indicated that a short-term fix will not help in the long run and urged lawmakers not to "make it harder to be an American company." Similarly, Senator John Thune (R-SD) highlighted the need to reform the "outdated, dysfunctional tax Code" that uses a worldwide system and imposes a high corporate tax rate, urging lawmakers to focus on creating an environment that is more competitive for American companies. Mr. Stack noted that, while the United States will never have the lowest corporate tax rate, it should take steps to ensure that companies want to stay in the United States.

A High Corporate Tax Rate. Ranking Member Hatch asked both Dr. Robinson and Dr. Merrill to discuss studies comparing the US effective corporate tax rate with the effective corporate tax rates of other countries. According to Dr. Robinson, accounting literature studies have searched for differences in accounting effective tax rates, but have not found evidence to suggest that US firms have higher accounting effective tax rates than non-US firms. However, according to Dr. Merrill, while studies commonly suggest that the US effective corporate tax rate is low, when compared to the effective corporate tax rate of non-US firms, the rate is generally in the top quartile internationally. According to Senator Chuck Grassley (R-IA), there can be little argument that the high US corporate tax rate leads to inversions.

Benefits of a Territorial Tax System. In response to a question from Ranking Member Hatch, Dr. Merrill highlighted Japan and the United Kingdom as two nations that switched from a worldwide tax system with deferrals to a territorial system. According to Dr. Merrill, implementing a territorial system, along with a 100 percent exemption for foreign dividends, made the nations more attractive to multinational corporations. Similarly, Mr. Desai suggested that US companies are at a competitive disadvantage when compared to companies headquartered in a country with a territorial tax system.

Role of Investors in Inversions. In response to a question from Senator Brown regarding the role that hedge funds, private equity funds, etc. have on inversions, Mr. Sloan indicated that such investors are "driven by profits" and place pressure on corporations to invert.

OECD and the BEPS Project. Ranking Member Hatch briefly addressed the OECD BEPS project, solely to urge both the OECD and Treasury to "keep Congress informed" and "not to get ahead" of them. Both Mr. Saint-Amans and Mr. Stack recognized the importance of working with Congress on these issues and pledged to keep lawmakers apprised of what is being done on the project.

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