DATE: October 3, 2017

FROM: Casie Daugherty, Prime Policy Group

SUBJECT: Senate Finance Committee Hearing on Tax Reform

Today, the Senate Finance Committee held a hearing entitled "International Tax Reform."

The hearing covered a wide range of issues pertaining to international tax, specifically that the U.S. should prioritize in transitioning to a territorial system. Base erosion and earnings stripping was covered at length. Also covered was bifurcating cash from non-cash assets, intellectual property and highly mobile intangibles, and the impact that changes to the U.S. tax system will have on Foreign Direct Investment (FDI). Subjects not limited to international tax issues, like whether it was feasible to finish tax reform in 23 legislative days, as is called for in the Senate Budget, were also discussed.

Committee Members' Opening Statements

Committee Chairman Orrin Hatch (R-UT)

Chairman Hatch thanked Ranking Member Wyden for looking at the tax issues with an open mind. He stated emphatically that the framework is not a complete plan by design. He also made a lengthy screed against the Tax Policy Center analysis of the GOP Framework. The Chairman stated, as he has at recent tax hearings that the Committee is responsible for writing the tax reform bill in the Senate and he prefers it be a bipartisan effort. He stated that international tax issues presented a lot of bipartisan opportunities. Chairman Hatch said that as a result of Subpart F, companies have engaged in complicated schemes to keep money offshore, around $2.6 trillion, thanks to the worldwide system. The solution is to transition to territorial system, which must be accompanied by enforceable anti-base erosion rules. These rules were endorsed in the Framework, as well as last year's Senate Finance bipartisan working group on international reform. Finally, he said that he wanted to better integrate the corporate and individual system, and that the international tax section in the Framework was particularly short on details because these problems cannot be solved in a 9-page framework.

Ranking Member Ron Wyden (D-OR)

Ranking Member Wyden emphasized that the Democrats were sticking to the principles that were included in the letter they wrote on tax reform but said that some of what was included was not far from what Chairman Hatch was talking about. He brought up his concern with the Trump Administration's commitment to facts, evidenced by removing a Treasury paper they didn't agree with on who benefits from corporate tax cuts. Wyden said that the Framework is a corporate wish list that gives corporations the greenlight to pay no taxes.

Witnesses' Opening Statements

Bret Wells, Professor of Law and George Butler Research Professor of Law at the University of Houston

Kimberly Clausing, Thromund A. Miller and Walter Mintz professor of Economics at Reed College

Stephen E. Shay, Senior Lecturer on Law at Harvard Law School

Itai Grinberg, Professor of Law at Georgetown University Law Center

Q&A Round 1:

Chairman Hatch: FDI fuels new jobs across the country. Dropping therate to 20% should increase job creation across the country. Do you believe that foreign multinationals have significant tax planning opportunities, such as earnings stripping that US multinationals don't have?

> **Mr. Wells:** There is no question that that is the case. The reason is that our only measure that restricts this is Subpart F that only applies to US resident companies. If you are not a resident company, you are not subject to that regime. A corporate inversion is just a US company saying that they want to be treated like a foreign company.
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> **Dr. Clausing:** I agree that we should even the treatment between foreign and U.S. firms.
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> **Mr. Shay:** I've said previously that we take steps to improve our source taxation. However, it is very important for Members to understand that there are structural advantages in every tax system in the world to advantage non-domestic companies.
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> **Mr. Grinberg:** I love foreign investment when it is actually creating jobs. This advantage makes foreign acquisitions more common. There is a study that says a transition to a territorial system would make the U.S. the acquirer, rather than the acquired 17% more.

Ranking Member Wyden: Secretary Mnuchin says that the tax cuts "pay for themselves." Do you believe tax cuts pay for themselves?

> **Mr. Wells:** By themselves, I don't think tax cuts pay for themselves.
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> **Dr. Clausing:** No.
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> **Mr. Shay:** No.
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> **Mr. Grinberg:** Appropriate tax reform can increase growth but only by a certain amount.

Ranking Member Wyden: One of the arguments for corporate rate reduction is that it will primarily benefit the U.S. worker. My understanding is that that mainstream consensus is that the benefit of tax cuts go to the shareholder, not the worker. Is that true?

> **Dr. Clausing:** That's correct. All the mainstream models (JCT, CBO, Treasury, TPC) all give 80% of benefits to shareholders.

Sen. John Thune (R-SD): The number of U.S. multinationals on the Fortune 500 has declined by over 25% from 2000. If we fail to capture trends in recent international tax reform that other countries have implemented, what is the cost?

> **Mr. Grinberg:** There are many costs. The one I'm most concerned about is the cost for our kids- they produce jobs that pay 1/3 higher than others. The other thing is, slowly the corporate tax break will drain away.

Sen. Thune: Do you see tax reform as being contemplated now leading to more economic growth?

> **Mr. Wells:** I absolutely think it will contribute to greater economic growth, but more importantly when we think about base protection, that will provide revenue for this Congress to meet other needs. You need to consider that foreign-based and inverted companies have "self-helped" themselves to a territorial system. No matter what you do, this country is territorial to them. The only question is whether there are the same rules for U.S. companies. It raises economic growth, but the way to raise revenue is to level the playing field.

Sen. Thune: In your testimony, you talk about how Congress should seek to give "leverage" when bargaining on an international level about "broadly-accepted rules that will be most likely agreed to at a later date. Can you elaborate on this, and what specific form do you see that leverage taking?

> **Mr. Grinberg:** Abroad, we see countries taking measures against U.S. companies (like the suggestion from the EU that they will do a "turnover tax" on digital business that will only go after U.S. tech companies). I'm suggesting a principle approach that we create an in-bound minimum tax to treat U.S. and foreign multinationals alike and defends the base that we can protect.

Sen. Debbie Stabenow (D-MI): One of the concerns I hear from MI, is the rising cost of prescription drugs. Despite record profits, many pharmaceutical companies have moved production and profits overseas. Do you think the proposal put forth last week will help solve any of these problems?

> **Dr. Clausing:** I didn't see anything that would address, in a serious way, tax base erosion. There was mention of a global minimum tax, which I don't think is a serious proposal.
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> **Mr. Shay:** In fairness, nothing other than the word "global" has been specified, so we have no idea what is being contemplated. If it is something that appears like any normal conception of a global minimum tax, which we have no idea what that will be, the average tax rate on foreign CFCs is 12.1%. So, if the minimum tax is below that, you certainly haven't accomplished much. Without a per country approach, it will be relatively toothless.

Sen. Stabenow: What steps should we be taking about drug companies not paying their fair share?

> **Dr. Clausing:** This is a big problem. Those companies on the Fortune 500 that have achieved effective tax rates in the single digits often have a lot of intangible value, which makes it easier to shift profits abroad. The approach that Mr. Shay and I have recommended is to lower the rate and combine that with eliminating deferral. If you go to a territorial system, a per country approach is better than many others. The higher that is and closer to the U.S. rate, the higher the disincentive.
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> **Mr. Wells:** A minimum tax under Subpart F would not apply to any pharma company because they are not a U.S. company any more. If you are looking for a minimum tax or something else, it simply doesn't apply to that sector.

Sen. Stabenow: One of the big things for me is closing loopholes that incentivize shipping jobs overseas. I have introduced the *Bring Jobs Home Act* for multiple years to take away the deduction for moving expenses. Would you support stopping the deduction for ordinary businesses expenses for a business moving overseas?

> **Mr. Wells:** I think that what we should have is base protection that broadly and comprehensively protects the U.S. tax base. Cherry-picking one observation is a bigger problem. It is not a solution.
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> **Dr. Clausing:** Yes.
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> **Mr. Shay:** I'm reluctant to pick out pieces.
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> **Mr. Grinberg:** It's peanuts, we should do something more comprehensive.

Sen. Rob Portman (R-OH): If we had a 20% rate and a territorial system, we would have 47 more U.S. companies, according to a recent EY study. Acquisitions and inversions are also significant problems. We haven't talked a lot about outbound companies. Countries that have a minimum tax system, like that referenced by Dr. Clausing and Mr. Shay (France, Germany, Japan), they have a carveout for active business exceptions. Can you comment on these carveouts and what we should consider when creating our own outbound base erosion rules?

> **Mr. Grinberg:** Territorial systems often have some rules for base protection that allow active business exception. The one under EU law is incredibly narrow. We should understand that if we are thinking about a similar rule, we would not want to create a rule with a higher substance requirement. The higher the substance bar, the more jobs you are asking to move offshore.

Sen. Portman: Increasingly, countries in the OECD are saying that it is fine to take advantage of a patent box, but then you have to move your R&D. On the outbound side, how do we strike the balance between U.S. competitiveness and making sure intangibles don't leave. What do you think about the idea that Treasury could do more with Section 367D?

> **Mr. Shay:** The patent boxes that I have examined, are very difficult to design and implement and end up mostly being rate reductions. With respect to how we achieve a balance, it comes down to not just looking at source or outbound taxation. We have to look at everything. If you don't have a robust minimum tax, you are going to have a problem.
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> **Mr. Grinberg:** The most important thing we can do is lower the rate. The other thing I hope we do is make it relatively easy during the transition to repatriate IP back into the U.S. You also want strong R&D incentives.
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> **Mr. Wells:** We all agree that lowering the rate would help. If you move to a territorial system, we are saying that Subpart F should not serve as an important backstop.
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> **Dr. Clausing:** Lowering the tax rate is not enough. Over 80% of the profit shifting is shifting to tax havens with rates of 2-3%. The key is to do tough base erosion provisions.

Sen. Bill Cassidy (R-LA): You talk about the importance of not bifurcating cash/cash equivalents from non-cash. Can you talk about that?

> **Mr. Shay:** I am not in favor of a reduced rate on pre-effective earnings, but if there is a different rate on earnings that are invested in illiquid assets versus cash, it is not a good idea to announce. You are better off with a better rate.
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> **Mr. Wells:** I agree with his assessment that people are going to have a reaction. The discussion we are having is only for U.S. companies.
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> **Mr. Grinberg:** On this point, I agree with his concern. One needs to be careful about announcing in advance.
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> **Dr. Clausing:** I agree.

Sen. Cassidy: Mr. Shay is making the point that we should have a country-by-country rate because of the issue of the minimum rate.

> **Mr. Grinberg:** My view is that we should have an inbound minimum tax, not an outbound minimum tax. This question would drop away. If there is an outbound approach, I would just point out that a country-by-country approach is not consistent with the way multinationals do business around the world. It is pretty unworkable.
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> **Mr. Wells:** I think it would be extremely complicated for the reasons that he touches on.

Sen. Cassidy: One of the challenges seems to be the treatment of highly mobile intangibles. Secretary Mnuchin said in their modeling that having an IP box would cost the U.S. money. What's the proper balance of carrots and sticks for IP?

> **Mr. Wells:** If you enact a targeted rule, all that does is tell the multinational to use a different tool. I would caution the Congress that instead of targeting IP or moving expenses, we need to deal with this as a holistic question.

Sen. Cassidy: I accept that point, but some industries are very IP-heavy.

Mr. Wells: There are two different aspects for this: inbound royalty stripping for the use of IP in the U.S., where we need better earnings stripping protections. The other is IP migration, where the Treasury Department should do move under Section 367D to prevent the shifting of intangibles for the U.S. to a foreign jurisdiction.

Dr. Clausing: Intangibles are an important part of the tax base erosion problem. We should look at what other countries are doing to protect their tax base.

Mr. Grinberg: We should have appropriate R&D incentives, and if you have appropriate inbound rules, it ends some of the incentives to move overseas.

Sen. Tom Carper (D-DE): Where do you find consensus among the four of you, assuming that we are moving closer to a territorial system?

Mr. Wells: I think we have agreement that earnings stripping, inbound base erosion, source tax, is a respected point of view.

Dr. Clausing: There is agreement on a lower rate and closing loopholes, as well as protecting against base erosion. I think at least three of us are concerned about inbound and outbound base erosion.

Mr. Shay: There is agreement that a strengthening of the source taxation and anti-abuse constraints is important.

Mr. Grinberg: We all agree that we need to look at inbound reform and lowering the rate.

Sen. Carper: You were at Treasury during the last big tax reform effort. What advice can you share?

Mr. Shay: At the time, there had to be a bipartisan agreement because the House and Senate were in different hands. Tax reform is in the details, you can't rush it, and it can't be done on the fly. It boggles my mind that we would try to do such massive changes on such a short timeframe for political objectives.

Sen. Ben Cardin (D-MD): On business tax issues, you all talked about harmonizing rules. The point is legitimate. The tax rate issues are also legitimate concerns. If we are really looking at harmonizing, it will be impossible on competitive business tax rate unless we look at harmonizing other revenues. Where is my logic wrong?

Mr. Wells: I wouldn't say you're wrong. I would say that an unlevel playing field needs to be fixed.

Mr. Grinberg: I would urge you not to make perfect the enemy of the good, and I specifically reference your proposal in my testimony. I am an advocate for a VAT, but we need to move on corporate tax reform now.

Sen. Michael Bennet (D-CO): Can we reform the tax code that doesn't have a significant number of issues if we rush it through in a period of 23 legislative days, as is called for in the Senate budget?

Mr. Wells: Without seeing legislative language, it is hard to know how far apart you are.

Dr. Clausing: It would be very difficult and you run the risk of losing a lot of revenue by doing the tax cutting part but not the base erosion part. It is a toothless system.

Mr. Shay: I agree with that. It's mind boggling that you could have such a major change with that little consideration.

Mr. Grinberg: We've had a six-year process on tax reform, but it depends on what the legislative language says.

Sen. Bennet: What's the risk, that we leave loopholes or we make mistakes that multinationals could take advantage of?

> **Mr. Wells:** It's hard to imagine that we could make more than we currently have. For me, there is an open field with no tacklers, being how bad the system is now.
> **Dr. Clausing:** We have a large problem at present but that doesn't mean it can't get worse.
> **Mr. Shay:** If you don't have strong anti-base erosion rules, the system can be so much worse.
> **Mr. Grinberg:** Inbound territorial system is not a toothless system, it is just a fundamentally different approach.

Sen. Johnny Isakson (R-GA): If you were told that you were changing the U.S. to a territorial system. What "teeth" would you install in that system?

> **Dr. Clausing:** I would have a tough per-country minimum tax. That is absolutely essential. I would also protect earnings stripping and other anti-inversion things like an exit tax would be important off-the-shelf things that would be easy to do.
> **Mr. Wells:** We want the business profits in the U.S. subject to one level of taxation, whether you are a U.S.- or foreign-owned company. We don't want to tax the inbound investor in a punitive way, but they should be on a level playing field.

Sen. Isakson: Georgia has benefited from a lot of Foreign Direct Investment. If you have different rates per country, could that impact the FDI?

> **Dr. Clausing:** I'm not suggesting different rates for inbound investment, so I don't think it would apply in this case.

Sen. Isakson: One thing struck me with your testimony, 90% of people born in the 1940s have out-earned their parents, but only 50% of those born in the 1980s will. You talk about a number of ways to fix that (increase the EITC, wage stabilization). Am I correct in that?

> **Dr. Clausing:** I talk about the EITC as an excellent way to combat that. I also mention wage insurance, which would mean that if you lost your job due to technological change or competition, you would be insured for some fraction your wages. It is currently part of our trade adjustment assistance for a small number of workers that could be expanded.

Sen. Pat Toomey (R-PA): Can you elaborate on how the current system is harmful to American workers?

> **Mr. Grinberg:** It is harmful in a number of ways. There is a fact that in many foreign markets, U.S. companies are disadvantaged because they face a worldwide system of deferral. We have created a disadvantage for U.S. companies within the U.S. There remains a "headquarters bias."

Sen. Claire McCaskill (D-MO): We know the average effective corporate rate is 22%. Agricultural and retail are paying 28% or more and other industries have effective rates in the teens. Can you point to anything specific in the plan that would prevent the current wide disparity between how much companies pay?

> **Dr. Clausing:** No, as it is specified now, there isn't a lot to hang your hat on.
> **Mr. Shay:** In some perspectives, the proposal would worsen the issue to the extent that it applies expensing to all assets. If you move to economic depreciation for all assets, you get more equity between companies.

Sen. Maria Cantwell (D-WA): How important is increasing the skill level to maintain U.S. competitiveness?

Dr. Clausing: There are a lot of aspects to competitiveness that are going underappreciated in this debate. Many of those things also require government revenue, which makes the attention to deficits important.

Mr. Wells: I agree with what Dr. Clausing is saying. To fund those objectives, we need revenue for the government.

Sen. Cantwell: What about investing in skilled apprenticeships?

Dr. Clausing: I think that is a good way to increase competitiveness because of technological change.