Professor Wells testified before the House Committee on Ways and Means’ Subcommittee on Select Revenue Measures on June 23rd. His testimony addressed how to encourage tax competitiveness and avoid tax base erosion, and is attached in full.

TESTIMONY OF PROF. BRET WELLS

HEARING ON TAX REFORM AND INVESTMENT IN THE UNITED STATES

U.S. House Committee on Ways and Means Subcommittee on Select Revenue Measures

June 23, 2011

Chairman Tiberi, Ranking Member Neal, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Bret Wells, and I am an Assistant Professor of Law at the University of Houston Law Center. I hold a JD (with honors) from the University of Texas School of Law. I have over twenty years of experience in the tax area, much of that time working in industry. I have previously served as Vice President -- Treasurer and Chief Tax Officer for BJ Services Company, which was an S&P 500 Index company until last year. In my prior industry position and in my current position in academia, I have had the opportunity to consider why expatriated and foreign-owned companies have a significant competitive advantage in the US marketplace over US-owned companies. n1

In this testimony, I would like to address the following items:

1. The issue of tax competitiveness.

2. The issue of tax base erosion.

3. An approach to achieve both tax competitiveness and prevent tax base erosion.

1. Competitiveness.

Let me start out by saying that I believe that tax competitiveness is a serious issue. When the US activities of US domestic companies are treated less favorably than the US activities of inbound competitors, a serious structural problem is created that deserves careful attention by Congress. Tax rules that treat the US activities of different economic participants differently will cause the tax disfavored economic participant to seek to become a tax-favored economic participant . . . or else they risk getting forcefully acquired. The capital markets demand that this occur. The recent corporate inversion phenomenon is a wake-up call about the serious implications of an unequal playing field. n2 Foreign-owned multinationals have a competitive advantage in the United States exactly because they are foreign-owned. Certain US multinationals with inbound investment activities share this advantage to some extent. The tax advantage afforded to inbound investors arises because of their ability to erode the US tax base through base erosion payments. Base erosion payments arise from related party transactions such as intercompany charges for
interest, rents, royalties, services fees, and from intercompany purchases and sales of tangible goods between a US affiliate and an offshore foreign affiliate. n3

Through effective tax planning, these base erosion payments can create "Homeless Income." The income from these base erosion payments is "homeless" in the sense that it is not subject to taxation in the United States where it originated nor is it taxed in the offshore country where it is received. Others have referred to this type of income as "Stateless Income," but regardless of nomenclature n4 the result is that inbound economic participants can create zero taxed income for a significant portion of their income arising from their US business activities. The ability to create Homeless Income, therefore, affords inbound taxpayers a significant tax advantage and creates an unlevel playing field.

Congress can respond to an unlevel playing field in one of three ways. First, Congress could choose to reduce all taxes for all business activity, thus making everyone tax-favored. Given the current fiscal budget crisis, I assume that this option is not feasible or prudent for the country. Second, Congress could choose to ignore the problem by saying that we should simply provide a tax advantage to inbound investors in order to create an extra incentive for those investors to participate in the US economy. Over time, this choice will cause tax-disfavored companies to transform themselves into tax-favored companies, and so in reality this second choice is much like the first choice except that the marketplace is the mechanism for converting tax-disfavored economic participants into tax-favored economic participants. The third alternative is for Congress to collect corporate taxes at a politically agreed-upon tax rate but to do so in a manner that attempts to tax the US activities of all corporations in a comparable manner, whether they are inbound investors or not. For the balance of my testimony, I will assume that Congress will want to proceed with this third approach.

2. Tax Base Erosion

How did it come to be that base erosion payments could be such a powerful tax advantage? To answer this question, it is helpful to consider the historical context for the foundational premises of the extant US international tax policy. In the early years, US multinationals were the dominate source of FDI around the world, and so US outbound investment far exceeded US inbound investment. In this economic setting, the United States government wanted to maximize the amount of residual profits that could escape source country taxation so that these residual profits could be taxed by the country that supplied the FDI, meaning the United States in the majority of cases. Residency taxation took preference over source country rights to tax. Furthermore, US transfer pricing policies maximized residual profits that could be reported by the country that held the intellectual property and was the source of capital and equipment, and so to further this policy the US tax treaties sought to require source countries to eliminate withholding taxes on interest, rents, and royalties in deference to the home country's sole right to assert taxing jurisdiction over these items of profit. The United States also relinquished its own withholding tax rights as a reciprocal measure, but again the trade flows were tilted in favor of the United States. In hearings before the House Ways and Means Committee in 1930, Professor Thomas Sewell Adams testified that the reduction in US withholding taxes was of no signif-icant concern because the United States treasury would be the net beneficiary if both countries reduced sourced based withholding taxes since the United States was a net capital exporter. n5
Thus, although the US source country tax rights have been purposely subordinated, this concession was made in the context of the United States government expecting that a greater amount of residual profits would flow into the United States treasury because of the reciprocal subordination of the source country tax rights of other countries. Today, the trade flows are reversed with the United States finding itself in the posture of a significant net capital importer. Furthermore, not surprisingly, taxpayers have reacted to these generous inbound tax rules and have taken full advantage of them. Today, inbound investors can use an offshore tax-favored subsidiary to transact with their US affiliate so that US origin profits can be earned in a country that chooses not to tax offshore income. This committee received testimony last month about the fact that many countries have adopted territorial tax regimes. Given that this is the case, the United States' continued willingness to allow base erosion payments to escape any US source country taxation allows large amounts of US origin profits to become Homeless Income due to the fact that many of our trading partners now disclaim taxation of extraterritorial income.

Homeless income is a mistake. US international tax policy was formed with the desire to prevent international double taxation. This is a worthy objective. But, the desire to prevent double taxation was never intended to have the consequence of creating Homeless Income out of US origin profits. In 1923, a group of economic experts issued a report to the League of Nations indicating their belief that over time that a significant majority of countries would eventually choose to tax their companies on a worldwide basis, and so relinquishing source country taxation would serve only to shift the incidence of taxation but would not be expected to change the amount. But, the world has evolved in exactly the opposite direction with many of the United States trading partners adopting territorial tax regimes. Income earned in the United States economy should bear one level of tax, and the assumption should now be that it won't be taxed anywhere else.

Homeless Income is a mistake that costs the United States treasury significant tax revenue. This mistake places inbound economic participants in a better economic position versus US companies that do not have these same base erosion opportunities. If left unfixed, this state of affairs will cause US companies to become prime take-over candidates or encourage them to engage in self-help efforts to transform themselves into the tax-favored economic participant. Again, the corporate inversion phenomenon is merely telling us what we already know.

Congress has reacted to this inbound advantage in the past by enacting targeted measures such as Section 163(j) and Section 897, but those remedies do not represent a comprehensive approach to protecting the US tax base from the full range of potential tax base erosion payments that exist. The basic issue is the following: inbound companies can utilize multiple avenues for stripping earnings from the United States tax base with the benefit of creating Homeless Income out of a significant portion of their US origin profits. Efforts to attack this problem through the Subpart F regime may close this base erosion loophole for the inbound activities of US multinationals, but these Subpart F reforms do nothing to change the fundamental loophole for the inbound activities of foreign-owned multinationals since these multinationals are generally not subject to the US subpart F regime. And, what is worse, attacking the Homeless Income problem via subpart F reforms are anti-competitive because they create a greater disparity between US multinationals versus foreign-owned multinationals. Thus, we need a policy
response that protects the US tax base against base erosion payments regardless of whether the
inbound base erosion strategies are conducted by a US multinational or by a foreign-owned
multinational.

3. Base Protecting Surtax  n7

In my view, the United States should consider imposing a gross "base protecting surtax" on any
base erosion payment made by a US payor to a foreign affiliate. The existing US transfer pricing
rules have done a fairly good job at ensuring that the routine operating profits of US affiliates are
reported in the United States, but those rules have not been successful at ensuring that the
residual profits created by activities in the United States are taxed in the United States. To
correct this situation, the presumption should be that base erosion payments strip residual profits
from the United States and a net basis tax of thirty-five percent (35%) should be owed on these
residual profits until proven otherwise. The surtax rate would need to be determined, but let's
assume for this discussion that a ten percent (10%) surtax on the gross amount of a base erosion
payment represents a reasonable upfront estimate of a net thirty-five percent (35%) tax after
considering allocable expenses.  n8

If the inbound multinational thinks that the 10% surtax is excessive versus the tax that would
have existed had the residual income been subjected to a 35% net basis tax after considering all
appropriate deductions, then it can disclose its foreign company's books and records so that the
IRS can correctly determine the actual residual net profits that deserve to be taxed in the United
States. If the taxpayer proves their case, then a refund of the excess portion of the surtax could be
given.  n9

When assessing the appropriate amount of US tax that should apply on residual profits, the
United States should use either a formulary apportionment or a profit-split methodology to
eNSure that the United States is able to tax its fair share of the residual profits of the combined
global income. Furthermore, in applying these transfer pricing methodologies, a functional
analysis should be performed to determine which country is entitled to tax the residual income,
and until proven otherwise the United States should start with the premise that the residual
profits are Homeless Income and should be taxed in the United States since they arose from the
United States. As a general matter, countries tax the functions that actually occur in their own
country, so the United States should not allow base erosion payments to escape US taxing
jurisdiction unless it is satisfied that some portion of the residual profits are rightly attributable to
the functions performed in the other country. Because this proposal uses existing transfer pricing
concepts of profit split or formulary apportionment to calculate the final tax, it satisfies the
guideposts of Article VII of the US tax treaties that require the United States to collect tax only
on the profits that are attributable to the United States.  n10

Thus, the presumption is changed. This proposal prevents Homeless Income before it is created
because it collects an upfront surtax on the gross amount of the base erosion payment. If the
foreign affiliate of a foreign-owned multinational does not wish to disclose their offshore books
and records, then at least a 10% gross surtax is collected and retained. But, for many inbound
multinationals, this proposal would create an incentive to be transparent and to work with the
IRS to determine the correct amount of tax that is due on the residual net profits arising from
their US inbound activities. Because current law allows base erosion payments to become Homeless Income, the IRS is left in the unenviable position of trying to defend the US tax base against a zero tax result through costly and expensive audits where they may have difficulty obtaining foreign books and records. An upfront surtax changes the incentives.

The intent of this recommendation is to ensure that residual profits do not get allocated away from the US taxing jurisdiction unless a true functional analysis is performed that considers the overall profits of the global company using a combined transfer pricing methodology. Protecting the US tax base against base erosion serves the goal of addressing the Homeless Income problem and serves to further the goal of not allowing inbound companies to create a competitive advantage. If inbound economic participants did not have a tax advantage over their domestic competitors, then the tax advantage of locating jobs overseas in order to supply products to the US marketplace would be reduced. To the extent that this proposal eliminates a tax handicap and equalizes the playing field for all economic participants, this proposal should serve to ensure that no US economic participant receives an unfair tax advantage and thus tax competitiveness concerns are addressed. Finally, to the extent that the United States can better collect taxes on inbound activities so that Homeless Income does not get created from US base erosion payments, such an effort would provide a source of much needed tax revenue by closing an unnecessary tax loophole.

Thank you again for the opportunity to testify.

FOOTNOTES:

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The views expressed here are solely my own views and do not necessarily reflect the views of University of Houston Law Center or of any prior employer.

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For a more extensive discussion of these advantages and how corporate inversions highlight these advantages, please see Wells, "What Corporate Inversions Teach Us About International Tax Reform," 127 Tax Notes 1345 (June 23, 2010).

n3
Staff of the Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010). Foreign affiliates owned by US multinationals generally cannot engage in base erosion strategies with a US affiliate that are premised on intercompany interest, rent, or royalty charges due to the Subpart F rules. See section 952(a)(2); section 952(b) (excludes US source income from subpart F income only if it is effectively connected income); section 954(c)(1)(A); section 956(a) (treats loans to US affiliates from controlled foreign corporations as investments in US property with the consequence that these investments trigger a subpart F inclusion to the extent of the unrepatriated foreign earnings and profits of the controlled foreign corporation). But, base erosion arising from intercompany service charges and from intercompany purchases and sales with a foreign affiliate may not be subject to current US taxation under the US subpart F rules and thus are available means to achieve base erosion. See Treas. Reg. section 1.954-4(a)(2) (managerial services can be charged
to the US affiliate without creating a subpart F inclusion by reason of the related party services income provisions of section 954 if those services are performed within the country of the service provider's incorporation); Treas. Reg. section 1.954-3(a)(4) (manufacturing exception); Treas. Reg. section 1.954-3(a)(1)(ii) (exempt commodity exception).

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See Statement of Dr. Thomas S. Adams, Hearings on H.R. 10165: A Bill to Reduce International Double Taxation before the House Ways and Means Committee, 71 Cong. 2d. Sess. at 47-48 (March 1, 1930), reprinted at Staff of the Joint Committee on Taxation, Legislative History of United States Tax Conventions (Vol. 1) at 33-34 (1962).

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n7
This proposal is more fully developed in an unpublished manuscript entitled Bret Wells & Cym Lowell, International Tax Reform: Source and Collection are the Linchpins" (unpublished manuscript).

n8
For the balance of this testimony, I focus on how the base protecting surtax would particularly apply to inbound taxpayers given that inbound issues are the focus of today's hearing, but it should be noted that this proposal applies to all base erosion payments and not just to base erosion payments of inbound taxpayers. As such, this proposal would also serve to address situations where US multinationals might attempt to earn excess residual profits in an offshore foreign affiliate through base erosion payments made to that foreign affiliate.

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The IRS could also be given authority to reduce the base protecting surtax to a lower amount if its application would be particularly excessive by providing a Base Clearance Certificate on the condition that the inbound company provide its foreign books and records and participate in a review process.

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See, e.g., Article VII(2) of the US Model Income Tax Convention (November 15, 2006).