Ways & Means Committee examines role of anti-base erosion provisions in reforming tax treatment of multinationals

At a June 13 Ways and Means Committee hearing, several House taxwriters, including Chairman Dave Camp, R-Mich., said the current international tax rules contribute to much of the problem of base erosion and that comprehensive reform would go a long way toward addressing the issue.

Camp draft

Camp opened the hearing by noting that many academics and economists maintain that base erosion options are a necessary part of tax reform to protect the U.S. tax base from the shifting of profits to low-tax jurisdictions. Although Camp identified profit shifting as a concern, he observed that these actions are the product of bad laws and a broken tax code; moreover, he argued, the fact that the code allows companies to achieve these results makes the case for comprehensive tax reform. Camp also emphasized that “the most effective anti-base erosion rule is a lower corporate tax rate.”

Camp then turned to the discussion draft on international tax reform that the committee released in October 2011. That draft – the first of three the committee has released on tax reform to solicit input from the public on overhauling the code – calls for a 25 percent corporate tax rate and moving the United States from its current worldwide system for taxing international income to a territorial system with a 95 percent dividends received deduction for foreign-source income. The draft also includes three base erosion options. (For additional details on the draft, see Tax News & Views, Vol. 12, No. 49, Oct. 26, 2011; for coverage of a Ways and Means Select Revenue Measures Subcommittee hearing on the draft, see Tax News & Views, Vol. 12, No. 54, Nov. 18, 2011.)

Of the three base erosion provisions, the so-called “Option C” has received the most support from the business community, Camp said. This option would create a new category of subpart F income for intangibles (foreign base company intangible income), that according to Camp would mean all foreign income attributable to intangibles would be taxed at a rate of 15 percent (minus foreign tax credits). In addition, this option would offset the subpart F inclusion with a deduction for income attributable to intangibles kept in the United States.

In his opening statement, Ways and Means Committee ranking member Sander Levin, D-Mich., expressed his concern over profit shifting. Like Camp, he blamed the tax code – including incentives for companies to shift jobs and profits overseas – as the source of many problems; but he expressed concern that the United States not get into “a race to the bottom” over rates.

Pascal Saint-Amans, director of the OECD center for tax policy and administration, explained the work of his organization in creating a model tax convention and transfer pricing guidelines. This had to be done cooperatively because of the inability of countries to address cross-border tax issues unilaterally, he explained. While the OECD’s initial focus was on preventing double taxation, Saint-Amans said that this had shifted over the years to preventing double nontaxation. In response, the OECD began a base erosion and profit-shifting project and released a report on the topic in February. Saint-Amans explained that the OECD’s concern is one of fairness because profit shifting can create an unlevel playing field.

Paul Oosterhuis, a tax lawyer in Washington, noted that the last large-scale changes to the international tax rules were in 1962 and 1986. Because we will be living with these rules for a long time, he cautioned the committee to be very careful in what it did, so as not to create other distortions.

Camp asked about Option C and whether it would help achieve neutrality between activities conducted in the United States and abroad. Oosterhuis said it did a good job by differentiating between products sold in the foreign market and those sold in the domestic market. He said that base erosion concerns under a territorial system would be about products sold in the domestic market and pointed to recent examples from the United Kingdom regarding inbound companies as an illustration of this concern.
Repatriation

Several members of the committee wanted to know about what the United States could do to end the “lockout” effect of the current code – that is, the disincentive companies have for repatriating income. Rep. Jim McDermott, D-Wash., noted that Congress had enacted a temporary repatriation holiday in 2004 and cited reports stating that companies that had repatriated the most money during the temporary holiday had reduced their U.S. workforce. He wanted to know who the real beneficiaries of the repatriation holiday had been.

Oosterhuis replied that the beneficiaries had been the companies’ shareholders, but he did not necessarily see a problem with this, as shareholders would likely spend or invest their repatriated income in the United States. When members asked whether repatriation should be tied to employment, Oosterhuis and Edward Kleinbard (a law professor at the University of Southern California and a former chief of staff at the Joint Committee on Taxation) both said no. Oosterhuis said it was better to set neutral rules, and Kleinbard warned against trying to micromanage business decisions.

Kleinbard, however, noted that much of the money that is said to be “trapped” outside the country is actually invested in the United States, but its availability is limited. Oosterhuis noted that a lot of the money is just sitting in banks and not being lent out, but he also said that the lockout effect distorts corporate decision-making and promotes a bias toward foreign assets.

Kleinbard also said that taxing the money currently held offshore would be a perfectly efficient tax. By this, he meant that because it would only affect old earnings, it would not affect any future economic behavior or create adverse behavioral consequences. In response to later questions from Republican Adrian Smith of Nebraska, Kleinbard further explained that he thought companies had been hoisted on their own petards. They achieved low tax rates offshore and now they are stuck holding the money offshore because of those low rates, he said.

Smith also asked if the experience of other countries could provide guidance on repatriation, but Saint-Amans said he did not think there were any good examples because this situation was unique to the United States. Oosterhuis said the United Kingdom’s experience might provide some guidance.

Right rate?

Rep. Vern Buchannan, R-Fla., asked what the right corporate rate should be in a reformed tax system. Kleinbard suggested his overall target rate of 25 percent, pointing to the OECD average, which Saint-Amans confirmed was about 24 percent. Oosterhuis said the rate would need to be lower because other countries’ rates continue to drop and incentives, such as patent boxes, reduce the statutory rates even further. He recommended a rate of 10 percent to 15 percent, especially if deferral was eliminated.

Manufacturing incentives?

Several taxwriters, such as Tom Reed, R-N.Y., and Linda Sanchez, D-Calif., were concerned about U.S. manufacturing and asked about what incentives should be retained in the code or enhanced as part of tax reform. Kleinbard and Oosterhuis were critical of incentives and agreed that simplification and rate reduction would do more for competitiveness than special incentives.

Oosterhuis said he thought that the Camp draft and Option C actually would encourage domestic manufacturing by allowing U.S.-manufactured products to bear a tax rate similar to those manufactured overseas. Kleinbard said reform would encourage foreign investment and pointed out that section 199 already gives a special rate for domestic manufacturing. He added that he did not think Congress should design a system that favors one industry over another or picks winners and losers.

— Jon Almeras
Tax Policy Group
Deloitte Tax LLP