Senate Finance Committee focuses on corporate inversions and the need for tax reform

July 22, 2014

In brief

The Senate Finance Committee today held a hearing to examine the need for comprehensive tax reform, focusing on recent reports of "inversions" involving cross-border merger and acquisition transactions in which the combined company has chosen to be legally headquartered outside of the United States. In their opening statements, Finance Chairman Ron Wyden (D-OR) and Ranking Member Orrin Hatch (R-UT) expressed support for comprehensive tax reform as the best long-term response to these concerns, with Chairman Wyden commenting that the "American tax code is an anti-competitive mess."

At the same time, Finance Committee members and hearing witnesses differed on whether Congress should take immediate action to address corporate inversions in advance of future action on comprehensive tax reform. Chairman Wyden said that the "inversion loophole needs to be plugged now," and referred to inversions as a "virus" that needs to be treated while the "ultimate cure" of comprehensive tax reform is being applied. Senator Hatch said that he did not support recent anti-inversion bills, but he was "open to considering alternative approaches" as long as they were not "retroactive or punitive" and were revenue neutral. Cautioning against some who would "use corporate inversions as a political wedge issue in an election year," Senator Hatch added that any action taken to address inversions must not impede overall progress toward comprehensive tax reform and movement in the direction of a territorial tax system.

The Finance Committee hearing also examined recent initiatives within the Organisation for Economic Co-operation and Development (OECD) to address base erosion and profit shifting (BEPS). Senator Hatch noted a concern in Congress that the BEPS project "could be used by other countries to increase taxes on American taxpayers," and sought assurances from officials representing the US Treasury Department and the OECD that the United States would not be "rushed into accepting a bad deal just for the sake of reaching an agreement."

In detail

The Finance Committee on July 22 held a hearing on "The US Tax Code: Love It, Leave It, or Reform It!," which focused on the need for future action to achieve comprehensive tax reform and whether intermediate steps should be taken to address a recent increase in corporate inversion transactions. The hearing also examined recent work within the OECD to address base erosion and profit shifting.

Witnesses at the hearing included US Treasury Department Deputy Assistant Secretary for International Tax Affairs Robert Stack and

OECD Centre for Tax Policy and Administration Director Pascal Saint-Amans. Additional witnesses were Dr. Mihir Desai, a professor of finance and law at Harvard University; Dr. Peter Merrill of PricewaterhouseCoopers' National Economics and Statistics Group; Dr. Leslie Robinson, a professor at the Tuck School of Business at Dartmouth College; and Allan Sloan, senior editor at large for *Fortune*.

Chairman Wyden, Senator Hatch opening statements

During the Finance Committee hearing, Chairman Wyden expressed a concern that the US tax code is "infected" with "loopholes and inefficiency" that act as a significant drag on the economy and harm US competitiveness. Chairman Wyden noted his work over the past nine years to offer bipartisan comprehensive tax reform bills, but a "growing wave of corporate inversions" needs a quicker response. Congress should "work together to immediately cool down the inversion fever," Chairman Wyden remarked.

Finance Committee Ranking Member Hatch stressed that comprehensive tax reform is the "ultimate answer," but noted his willingness to consider proposals that were not punitive or retroactive and that would not raise revenue or detract from future tax reform efforts. Senator Hatch also cautioned that proposals to "build walls around US corporations in order to keep them from inverting" could result in making US companies "more attractive acquisition targets for foreign corporations."

Treasury testimony, Member responses

During his testimony, Treasury Deputy Assistant Secretary Stack noted President Obama's 2012 framework for business tax reform calling for a lower corporate tax rate and a minimum tax on the foreign earnings of US corporations. He also referred to the Administration's FY 2015 budget that includes proposals to tighten rules against earnings stripping and discourage corporate tax base erosion through transfers of intangibles. Stack cited a July 15 letter by Treasury Secretary Jack Lew calling for Congress to act immediately on inversion legislation retroactive to May 2014.

Senator Hatch expressed a concern that Secretary Lew's letter was "very politically-toned," and represented an effort to make inversions a political issue in advance of the November elections. Senator Jon Thune (R-SD) said that "accusations of not being economic patriots" were not helpful, and that the real problem is the United States having the highest corporate tax rate in the world.

Witness observations

Harvard University professor Mihir Desai testified that recent merger transactions reflect "long-simmering problems" with the US tax code, and cautioned against narrowly focused legislation that "runs the risk of being counter-productive."

PwC economist Peter Merrill testified that the US tax system "falls far outside global norms" by having the highest corporate tax rate in the world and by taxing the foreign earnings of US companies on a worldwide basis while 93 percent of competitors in the OECD benefit from a territorial tax system. He noted that the United Kingdom and Japan have moved in recent years to reduce their corporate tax rates and adopt territorial tax systems. Merrill added that a number of companies that had left the United Kingdom returned to that country after tax reforms were implemented.

Dartmouth College business professor Leslie Robinson joined other witnesses in calling for corporate tax reform to significantly lower the US corporate tax rate, but suggested that limiting the deferral of taxation on foreign earnings would be better than moving toward a territorial tax system. Robinson noted that countries with territorial tax systems may need to impose costly anti-abuse regimes, concluding that a lower US corporate tax rate coupled with limits on deferral would be the preferable approach.

Fortune editor at large Allan Sloan testified that inversions should not be a political issue but action is needed now to "avoid the loss of billions of dollars of US tax base." Sloan expressed support for a temporary anti-inversion legislation proposed by Senator Carl Levin (D-MI) (see below).

Finance member comments

While Finance Committee Democrats generally expressed support for action this year to address inversions, Senator Charles Schumer (D-NY) expressed concern about "management and control" proposals in recent anti-inversion bills that would treat a merged company domiciled in a foreign country as a domestic US company for tax purposes if management and control of the merged company remains in the United States. Senator Schumer said that such proposals could result in corporate headquarters leaving the United States. At the same time, Senator Schumer called for anti-inversion legislation to include new proposals to limit interest deductions of past and future inverted companies.

Several Republicans on the Finance Committee expressed concerns about proposals to address inversion transactions separately from comprehensive tax reform. Senator Charles Grassley (R-IA) said he opposes new restrictions on inversions but said earnings stripping rules should be examined. Senator Rob Portman (R-OH) called on the Obama Administration to take a more active role in pushing for action on tax reform, and expressed concerns that a short-term fix to address inversions would represent a detour away from comprehensive tax reform and could hurt the US economy by making American companies more attractive targets for foreign acquisitions.

Recent anti-inversion proposals

During today's hearing, Chairman Wyden did not endorse any specific legislative proposals. In a May 9 Wall Street Journal op-ed, Chairman Wyden said he is committed to tightening existing anti-corporate inversion rules as part of comprehensive tax reform; more recently he has called for intermediate steps to address inversion transactions. In his Wall Street Journal op-ed, Chairman Wyden said he would modify existing anti-inversion provisions under section 7874, effective for transactions occurring from May 8, 2014, to reduce the continuity of shareholder ownership threshold from 80 percent to 50 percent.

On May 20, House Ways and Means Committee Ranking Member Sander Levin (D-MI) and Senate Permanent Subcommittee on Investigations (PSI) Chairman Carl Levin (D-MI) introduced almost identical bills (H.R. 4679, S. 2360) to tighten existing anti-inversion rules under section 7874. Both bills are proposed to be effective for transactions completed after May 8, 2014. The Senate bill is proposed to expire after a two-year period, in anticipation of Congress enacting comprehensive tax reform legislation, while the House bill would not sunset.

The bills introduced by Rep. Levin and Senator Levin are similar to a proposal in President Obama's FY 2015 budget to broaden significantly the definition of an inversion transaction under section 7874. Under the Administration's budget proposal, a foreign corporation generally would be treated as a US corporation for US tax purposes where (among other requirements) it acquires substantially all the assets of a US corporation and there is greater than 50 percent continuity of ownership in the foreign acquiring corporation by the shareholders of the acquired corporation. The Administration budget proposal also would add a special rule whereby, regardless of the level of shareholder continuity of ownership, an inversion transaction is deemed to occur if (1) a foreign corporation acquires substantially all the assets of a US corporation; (2) the affiliated group that includes the foreign corporation has substantial business activities in the United States; and (3) the foreign corporation is primarily managed and controlled in the United States.

OECD BEPS proposals

Treasury Deputy Assistant Secretary Stack testified that the OECD BEPS project is a response to "public frustration" in G20 countries that "arises when companies that do business in one country pay low or no tax there or anywhere else." His written testimony states that the Treasury Department would work hard to preserve US national interests and would guard against long-standing transfer pricing principles turning into "vague concepts easily manipulated by countries to serve their revenue needs at the expense of the US tax base and our multinationals." He also testified that proposed country-by-country reporting should be used by countries' tax administrators solely as a risk assessment tool, and information on US-based multinationals should be protected under existing US treaties and information exchange networks.

In response to concerns raised by Senator Hatch and others, OECD Director Saint-Amans testified that the OECD was committed to respecting its tradition of consensus and would continue to keep the US Congress informed of work on various BEPS proposals. Saint-Amans said that the goals of the OECD BEPS proposals are to provide tax certainty and avoid unilateral moves that depart from international norms and consensus. He added that the OECD is committed to a cost-effective approach to reduce compliance costs.

Hearing testimony

Click here for copies of Finance Committee hearing opening statements and witness testimony.

Joint Committee on Taxation report on international tax reform proposals

In advance of the Finance Committee hearing, the Joint Committee on Taxation (JCT) released a 96-page report on present law and background on recent proposals to reform US international tax laws. Click here for a copy of the JCT staff report.

The takeaway

The Finance Committee's hearing on international tax issues demonstrated that there is bipartisan interest in comprehensive tax reform. However, there did not appear to be bipartisan agreement on legislation to address inversion transactions. In addition, House Ways and Means Chairman Dave Camp (R-MI) has said that he opposes efforts to address cross-border mergers and acquisitions separately from comprehensive tax reform.

Congress is not expected to act on comprehensive tax reform legislation in 2014 but the current debate over corporate inversions and proposals to change US international tax rules can be expected to influence future tax reform legislation.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

Tax Policy Services

Pam Olson
(202) 414-1401
pam.olson@us.pwc.com

Rohit Kumar
(202) 414-1421
rohit.kumar@us.pwc.com

Ed McClellan
(202) 414-4404
ed.mcclellan@us.pwc.com

Lindy Paull
(202) 414-1579
lindy.paull@us.pwc.com