

TESTIMONY OF PROF. REUVEN S. AVI-YONAH
HEARING ON TRANSFER PRICING ISSUES
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My name is Reuven S. Avi-Yonah. I am the Irwin I. Cohn Professor of Law and Director of the International Tax Master of Law Program at the University of Michigan Law School. I hold a JD (magna cum laude) from Harvard Law School and a PhD in History from Harvard University. I have twenty years of full and part time experience in the tax area, and have been associated with or consultant to leading law firms like Wachtell, Lipton, Rosen & Katz and Cravath, Swaine & Moore. I have also served as consultant to the US Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair of the ABA Tax Section Committee on Tax Policy, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published fourteen books and over 90 articles on various aspects of US domestic and international taxation, including transfer pricing, and have fifteen years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

I would like to thank Chairman Levin, Ranking Member Camp and the Committee for inviting me to testify at this important hearing. My testimony will address the following:

1. The importance of transfer pricing
2. The data on profit-shifting by US-based multinationals (MNEs)
3. Some proposed solutions

1. Why is transfer pricing important?

Transfer pricing is and has always been a central element of international taxation. The international tax rules are designed to define the amount of income from cross-border transactions that can be taxed by each taxing jurisdiction. Thus, a key issue in international taxation is how much income is earned by MNEs within a taxing jurisdiction. Transfer pricing involves directly the allocation of income among various taxing jurisdictions and therefore determining the correct transfer price directly influences how much revenue each jurisdiction can collect from cross-border transactions.

In the current US context, transfer pricing is even more important, because resolving it is the key to progress on the long-lasting debate between advocates of worldwide and territorial taxation. Since Subpart F was enacted in 1962, the debate surrounding the US international tax rules has revolved around the extent to which the US should tax the foreign source income of US-based multinationals (MNEs). On the one hand, opponents of deferral argued that the US should tax currently all of the income earned by subsidiaries of US-based MNEs. On the other hand, critics of Subpart F argued that the US should exempt the foreign source-income of US-based MNEs even when it is repatriated. Current law, which permits deferral for most income but requires

current taxation of Subpart F income and taxes repatriated active income, was seen as an uneasy compromise.

Both of these positions are still around.¹ However, in recent years a consensus has emerged around a middle of the road position. In the centrist view, the US should continue to tax currently passive income earned by US-based MNEs and should retain the foreign tax credit, but should exempt dividend distributions from active income.

There are three major arguments in favor of shifting the US international tax regime in the direction of territoriality. The first argument is that because corporate residence is not a particularly meaningful concept, it makes little sense to base the entire US international tax regime on it. The current regime provides an impetus for inversions and for original incorporations of firms overseas, and the data suggests an increase in both phenomena in recent years.² Corporate taxation should fundamentally be source-based, with exceptions as needed to protect the US corporate tax base.

The second argument is that in recent years, all of our major trading partners have moved in the direction of territoriality, including recently the UK and Japan, the two other major worldwide taxation regimes. We should act to align our international tax rules with those of our trading partners, to limit the incentive to form MNEs elsewhere.

Finally, it has been shown that the current US international tax rules result in very little US tax being collected on the foreign-source income of US-based MNEs (around a 2% effective tax rate), but that it has significant effects on their behavior.³ Taxes can generally be judged by comparing the revenue they collect with the welfare-reducing changes in behavior they induce, and a tax that collects little revenue while inducing massive behavioral shifts is a bad tax.⁴ This means that any reform could be revenue neutral while reducing the disincentives to repatriation faced by US-based MNEs.

However, this reform cannot be adopted under the current transfer pricing rules without risking a significant revenue loss. Without transfer pricing reform, territoriality will in my opinion lead to an even stronger incentive to shift profits overseas, and to further revenue losses and erosion of

¹ See Gregg/Wyden, The Bipartisan Tax Fairness and Simplification Act of 2010 (abolishing deferral); Dan Shaviro, Rethinking Foreign Tax Creditability (National Tax J., December 2010) (full territoriality, no foreign tax credit).

² Dharmapala and Hines, Which Countries Become Tax Havens?, 93 J. Pub. Econ. 1058 (2009).

³ Altshuler and Grubert, Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of US Multinational Corporations, 54 National Tax J. 787 (2001).

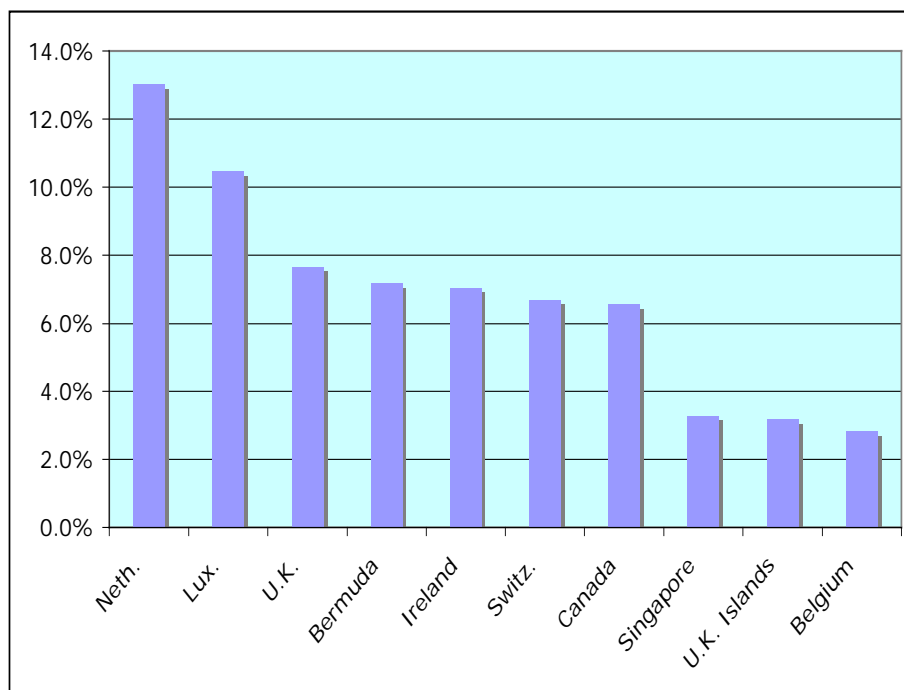
⁴ The results of the one year experiment of reducing the tax on repatriations in 2004-5, which led to over \$300 billion in repatriations, prove the behavioral effect.

the US corporate tax base.⁵ Thus, I believe that the key to any international tax reform must be a transfer pricing overhaul.

2. The Data.

The following two tables illustrate the scope of the transfer pricing problem. The first summarizes the top ten locations where US-based MNEs located their profits in 2005 (the most recently available data), while the second indicates where jobs were located.⁶

Figure 2: Where Were the Profits in 2005?
(profits as a percentage of the worldwide total)



Country	Effective Tax Rate
Netherlands	5.1%
Luxembourg	0.9%
United Kingdom	28.9%
Bermuda	0.9%
Ireland	5.9%
Switzerland	3.5%

⁵ See Avi-Yonah, Comment on Yin, Reforming the Taxation of Foreign Direct Investment by US Taxpayers, 28 VA. TAX REV. 281 (2008).

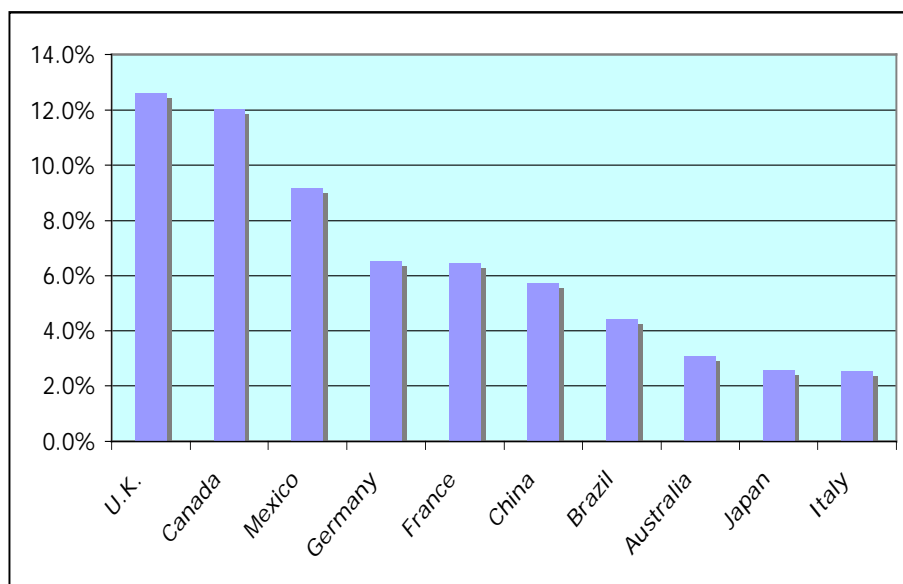
⁶ See Clausing, Multinational Firm Tax Avoidance and Tax Policy, 72 Nat'l Tax J. 703 (2009). See also United States Government Accountability Office, U.S. Multinational Corporations, Effective Tax Rates Are Correlated with Where Income Is Reported, Report to the Committee on Finance, U.S. Senate, August, 2008; U.S. Department of the Treasury, Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, November 2007; Martin A. Sullivan, "Extraordinary Profitability in Low-Tax Countries," Tax Notes (August. 25, 2008).

Canada	21.4%
Singapore	3.2%
U.K. Islands	1.9%
Belgium	8.7%

Notes: In 2005, majority-owned affiliates of U.S. multinational firms earned \$336 billion of net income. This figure shows percentages of the worldwide (non-U.S.) total net income occurring in each of the top-10 income countries. Thus, each percentage point translates into approximately \$3.4 billion of net income. Effective tax rates are calculated as foreign income taxes paid relative to net (pre-tax) income. Data are from the Bureau of Economic Analysis (BEA) web page; 2005 is the most recent year with revised data available. The Bureau of Economic Analysis conducts annual surveys of *Operations of U.S. Parent Companies and Their Foreign Affiliates*.

Figure 3: Where Were the Jobs in 2005?

(employment as a percentage of the worldwide total)



Country	Effective Tax Rate
United Kingdom	28.9%
Canada	21.4%
Mexico	21.8%
Germany	26.2%
France	21.3%
China	14.8%
Brazil	18.1%
Australia	12.1%
Japan	34.7%
Italy	24.9%

Notes: In 2005, majority-owned affiliates of U.S. multinational firms employed 9.1 million employees. This figure shows percentages of the worldwide (non-U.S.) total employment occurring in each of the

top-10 countries. Thus, each percentage point translates into approximately 91,000 jobs. Effective tax rates are calculated as foreign income taxes paid relative to net (pre-tax) income. Data are from the Bureau of Economic Analysis (BEA) web page; 2005 is the most recent year with revised data available. The Bureau of Economic Analysis conducts annual surveys of *Operations of U.S. Parent Companies and Their Foreign Affiliates*.

As Kim Clausing has argued, these data indicate clearly that US-based MNEs are able to locate most of their overseas profits in locations where they have limited real presence and where the effective foreign tax rate is low. Similar results could probably be obtained for foreign-based MNEs if the data were available.

From a US perspective, there are two principal reasons for this state of affairs. First, US-based MNEs are able to shift profits from intangibles, which account for the bulk of their total profits, overseas via cost sharing agreements. Second, IRC 954(c)(6) enables them to shift profits from high to low-tax foreign jurisdictions without current US taxation under Subpart F.

This state of affairs is undesirable because it leads to an erosion of the US domestic corporate tax base. As stated above, this incentive will be strengthened if we adopt limited territoriality.

3. Some Proposed Solutions.

This section sets out some proposed solution to the transfer pricing problem. In addition, the pressure on transfer pricing would be somewhat relieved if we aligned our corporate tax rate with the Organization for Economic Cooperation and Development (OECD) average (around 24%). This could be achieved in a revenue neutral manner by broadening the domestic corporate tax base (as was recently done in the UK).

a. Formulary Apportionment.

As my co-authors Kim Clausing and Michael Durst and I have argued, one possibility is to adopt a formula (which we suggested should be sales-based) to split profits left over after routine contributions by the related affiliates are accounted for.⁷ Such a reform can be enacted by Congress, and we have included proposed legislative language in our article.

However, our proposals have not so far persuaded opponents of formulary apportionment (FA). Instead, the advocates of the Arm's Length Standard (ALS) point to a list of asserted deficiencies of FA, including:

1. FA is inherently arbitrary;
2. FA will produce double taxation because some countries will apply the ALS and others FA, and the FA countries will each have a different formula;
3. FA requires an impossible to achieve uniformity of the tax base;
4. FA violates tax treaties;
5. FA will be impossible to enact because of the opposition of the multinationals and of countries that will lose from its implementation.

⁷ Avi-Yonah, Clausing and Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, Florida Tax Rev. (2009). See also Michael C. Durst, *Memo to Congress: Reform Transfer Pricing and Protect U.S. Competitiveness* (Tax Notes, July 26, 2010, forthcoming).

We believe that there is a good answer to each of these arguments, and have in fact replied to them at length elsewhere.⁸ However, I also realize that my answers are unlikely to persuade FA opponents. Thus, I want to use this testimony to propose a more modest step forward: adopting FA only in the context of ALS (rather than replacing the ALS with FA).

The basic problem arises in situations where there are no good comparables. If good comparables exist, the traditional methods (comparable profit method (CUP), cost plus and resale price) can be used, and that would end the story. But in the vast majority of cases good comparables are impossible to find.⁹ If comparables cannot be found, the distinction between ALS and FA becomes a matter of semantics, not substance. Where there are no comparables, it is impossible to establish what unrelated parties would have done, and therefore the result obtained under FA is consistent with ALS (because it cannot be shown to be inconsistent with it).

The next possible alternative under the OECD Guidelines is the Transactional Net Margin Method (TNMM). However, TNMM requires a tougher comparability test than the US Comparable Profit Method (CPM), which is good because CPM has proven to be the most manipulable of the current methods: An informed economist working for a major accounting firm has told me he can achieve any result the client wants using CPM. CPM is also a huge source of transactional complexity, a boon to the large accounting firms, and a problem for those who cannot afford their services. But the tougher OECD TNMM comparability standard means that TNMM cannot be applied in many cases in which CPM is used in the US.

This leaves Profit Split. Under Profit Split, comparables are used to allocate the return on routine functions.¹⁰ But that usually leaves a residual in place, which arises precisely because multinationals exist to earn a return that cannot be achieved in an arm's length relationship. That, as explained above, is why good comparables are hard to find.

Thus, the key issue in current transfer pricing is how to allocate the residual under the Profit Split method. The US regulations assume that the residual is the result of high profit intangibles and allocate it to where such intangibles were developed. However, this method

⁸ Avi-Yonah, Clausing and Durst, *supra*; on the treaties point see also Avi-Yonah, Reuven and Kimberly A. Clausing. 2008. "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment." In Jason Furman and Jason Bordoff, eds. *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes*. Brookings Institution Press. 319-44.

⁹ That was the conclusion of the GAO from a study done in the early 1990s for the three traditional methods. Comparables are easier to find under CPM, but that is because the standard of comparability is too loose.

¹⁰ An easier method would be to allocate standard returns by a formula based on expenses, as suggested in Avi-Yonah, Clausing and Durst, *supra*. It is doubtful whether the return on routine functions can in practice be segregated from the total profit of the MNE.

is not helpful because (a) the OECD and the rest of the world rejects it, (b) it penalizes multinationals for conducting research and development (R&D) in the US, and (c) it encourages multinationals to enter into cost-sharing agreements that artificially shift profits to low tax jurisdictions. In addition, as the *Bausch & Lomb* court stated, if the value of the intangible results from the fact that two parties are related, that added value is distinct from where it was developed. Neither the location of the intangible nor the location of risk (both of which in reality pertain to the MNE as a whole) are helpful in locating the residual.

If the US approach is rejected, the question is how to allocate the residual. The OECD Guidelines are silent on this issue. This presents an opportunity: Perhaps in this context, it should be possible to adopt a formula to allocate the residual.

One needs to realize that if there are no comparables (by definition) and the residual results from the relationship between the parties and would disappear if they were unrelated, then the ALS is meaningless and any allocation is arbitrary. Under these circumstances the key is to adopt the formula that is most likely to achieve consensus.

In the unilateral US context, my co-authors and I support a sales-based formula similar to the destination-basis formula for Value Added Tax (VAT). This choice of formula favors exports and therefore is likely to be politically popular, and it favors the US because of our trade deficit.¹¹ In the OECD context, I would prefer a more balanced formula with three components- payroll, tangible assets and sales.

These three components are of course the traditional US state FA formula. This formula has proven to be remarkably successful, since in addition to the US states, it is also the basis for the global dealing regulations in the US and OECD, and is a leading candidate for the European Common Consolidated Corporate Tax Base (CCCTB) formula. I believe it makes sense because each of its elements is objective (payroll and sales are transactions with outside parties, and while tangible assets depend on valuations, there is a lot of experience with asset-based formulas, such as the US interest allocation formula). Intangibles are excluded, but in my opinion that is appropriate because (a) their value results from physical and human capital and from the market and those elements are included, and (b) you cannot allocate their value and trying to include them invites manipulation.

Thus, I would propose that in hard transfer pricing cases, in which no comparables can be found beyond the return on routine functions, the US should adopt and the OECD should endorse using the traditional three factor state formula to allocate the residual under the Profit Split method.

I believe this proposal addresses the problems with FA outlined above:

1. While the formula is arbitrary it relates to economic reality, and any allocation is arbitrary in the absence of comparables. The current OECD Guidelines are also arbitrary in not allocating residuals.

¹¹ Avi-Yonah and Clausing (2008), *supra*.

2. It is unlikely that this outcome would lead to more double taxation than what already occurs for residuals under the ALS. If the US allocates residuals based on location of R&D and other countries disagree, double taxation is already a threat. Disputes can be resolved using the new arbitration provision under the OECD model.
3. If the OECD accepts the residual formula under ALS, it does not violate treaties and it can be handled in the context of Article 9.
4. Since it is only a residual formula, the base has already been defined under ALS.
5. A balanced formula is less likely to produce consistent losers.

b. Reforming Cost Sharing.

Intangibles are responsible for much of the profit of modern MNEs, and it has been argued that they are the main reason why MNEs exist. Current law, however, creates opportunities for companies to shift profits in the form of royalties from high to low-tax jurisdictions without incurring current US tax liability.

The key issue is a transfer pricing one: If intangibles are developed in the US, the income related to them should be taxed in the US. That was Congress' intention when it added the second sentence (the "super-royalty" or "commensurate with income" rule) to IRC 482 in 1986. However, under the cost-sharing regulations as they existed until the recent amendments, it was possible for a US-based MNEs to locate most of the profit from an intangible in an offshore jurisdiction solely because the CFC participated in the costs of developing the intangible. The CFC was not required to participate in the research in any way other than a monetary contribution (which could be a capital contribution from the parent).

Recent amendments to the cost-sharing regulations have tightened the requirements for a CFC to participate in a qualified cost sharing arrangement.¹² I believe that these regulations will significantly limit the ability of US-based MNEs to shift profits from intangibles developed in the US to their overseas CFCs. I would support further amending the regulations so that cost sharing would only apply to intangibles developed with substantial participation by the CFC. If a US-based MNE develops an intangible jointly with its CFCs, cost-sharing is an appropriate way of allocating the resulting profit between the related parties. But cost-sharing should not be applied to allocate profits to a CFC that did not actually participate in developing an intangible.

c. Reforming IRC 954(c)(6).

Legislation recently introduced by Rep. Doggett would eliminate the application of IRC 954(c)(6) to royalties.¹³ IRC 954(c)(6) was enacted in 2006 in order to enable US-based MNEs to shift profits among their subsidiaries (CFCs) without triggering Subpart F inclusions. The argument was that MNEs were able to achieve the same result by using "check the box" (i.e.,

¹² Treas. Reg. 1.482-7T (2009).

¹³ H.R. 5328, The International Tax Competitiveness Act.

treating their CFCs as branches), and that the resulting reduction in foreign taxes paid would ultimately benefit the US because it would reduce creditable taxes and increase residual US tax upon repatriation.

The latter argument becomes irrelevant if we adopt territoriality. The “check the box” argument depends on whether the ability of US-based MNEs to shift profits from one foreign jurisdiction to another is key to their competitive position. I believe the answer is no, because most of our trading partners do not have rules analogous to “check the box” and they generally tax the passive income of their MNEs. Moreover, several EU jurisdictions such as Germany have recently enacted rules that make profit shifting more cumbersome.

The focus on royalties is appropriate because royalties are tied to intangibles, and the ability to locate intangibles in low-tax jurisdictions is key to the pattern outlined above. In addition, the other major form of shifting profit is interest payments, and those are addressed by thin capitalization rules the our trading partners have adopted.

Thus, I support the Doggett proposal on royalties and IRC 954(c)(6). This proposal addresses a major way in which US-based MNEs shift profits from high-tax to low tax jurisdictions, which as the Joint Committee report states has the potential of reducing the US tax base.¹⁴ It strikes a reasonable compromise between the need to preserve the US tax base, which is threatened if US-based MNEs can easily shift profits to low-tax jurisdictions, and the need to give US-based MNEs a reasonable measure of flexibility in moving income among their CFCs without incurring US tax.

4. Conclusion.

Reforming transfer pricing is the key to making progress toward reforming the US international tax rules. In the absence of transfer pricing reform, any move toward territoriality risks further erosion of the US tax base. Therefore, I believe it is imperative that Congress act to bolster our transfer pricing rules along the lines outlined above.

¹⁴ Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 (July 20, 2010), 9.