

Testimony before the Committee on Ways and Means,
United States House of Representatives
Washington, DC
July 22, 2010

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Chairman Levin, Ranking Member Camp, and Members of this distinguished committee, it is an honor to participate in these hearings on transfer pricing. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the Department of Economics, the L. Hart Wright Collegiate Professor of Law in the Law School, and Research Director of the Office of Tax Policy Research. I am also a Research Associate of the National Bureau of Economic Research, Research Director of the International Tax Policy Forum, and Co-Editor of the Journal of Public Economics.

As the Committee is well aware, transfer pricing is an intrinsic element of the current separate accounting system of international taxation. When a taxpayer earns income using operations in more than one country, it is necessary to attribute income to each location in order to determine how much tax is owed to each jurisdiction. The current practice throughout the world is to require business operations to keep separate accounts, on the basis of which taxpayers determine how much income they earn in each location, and what their accompanying tax obligations should be. Separate accounting requires that affiliates of the same multinational firm attach prices to any valuable business inputs, such as tangible and intangible property, that they provide to each other, and use these prices in calculating net income by including income from intercompany transfers while subtracting the cost of inputs received in intercompany transfers. Prices used for intercompany transfers are known as “transfer prices,” and their use makes it

possible to determine how much income is earned in each location, and therefore how much tax is owed.

The calculation of taxable income using transfer prices for transactions between related parties located in different countries is analogous to the procedure by which purely domestic income is taxed, with three noteworthy exceptions. The first exception is that, if entirely unregulated, the reported prices of transactions between related parties located in countries with differing tax rates would be highly suspect, since taxpayers would have incentives to manipulate these prices to reduce total tax obligations. The second exception is that more than one government is an interested party in the determination of how much income is earned in each jurisdiction, since income attributed to one location is not attributed to another. And the third exception is that international transfer pricing is relevant only to multinational firms, which commonly confront different business situations than do domestic firms.

The international regulatory norm is that transfer prices are not subject to the discretion of taxpayers, but are instead required to correspond to arm's length prices, those that unrelated parties would use for the same transactions. The arm's length standard is attractive in part because, properly applied, prices determined in this way are not subject to manipulation by self-interested taxpayers. But that is only part of the attractiveness of the arm's length pricing rule; the more important point is that arm's length pricing produces taxable incomes that correspond to economic incomes. If the goal of the tax system is to tax income that is earned in the taxing jurisdiction, then arm's length pricing is the rule that governments should use to measure income for tax purposes. There are many pricing rules that would limit the manipulability of the location of taxable income – any pricing rule in which taxpayers do not have choices, including odd alternatives such as government-chosen random prices, would suffice – but most would be

ridiculous in the context of income measurement. Arm's length prices are market prices, which correspond to the prices that properly measure income. That is why the United States and virtually all other countries in the world have adopted the arm's length standard for international transfer pricing.

The Magnitude of the Transfer Pricing Problem

As has been widely noted, a system of separate accounting gives taxpayers incentives to adjust the prices of intrafirm transactions in order to reduce their total tax obligations. Typically taxpayers would benefit from reducing their taxable incomes in high tax countries and increasing their taxable incomes in low tax countries, since total tax obligations thereby decline. This adjustment of taxable incomes might be accomplished either by reducing the transfer prices of goods and services provided by affiliates in high tax locations to related parties in low tax locations, or by increasing the transfer prices of goods and services provided by affiliates in low tax locations to related parties in high tax locations. Given the application of the arm's length standard, however, the ability of taxpayers to adjust prices in this way is tightly constrained by tax laws and regulations in almost all countries. In particular, the tax authorities in high tax countries, of which the United States is a leading example, are well aware of the possibility that transfer prices can be adjusted to reduce local taxable incomes, and energetically enforce the arm's length standard in efforts to minimize the consequences.

How serious a problem is transfer pricing for a country like the United States? Since we have one of the highest statutory corporate tax rates in the world there is a clear incentive for many taxpayers to earn taxable incomes in countries other than the United States if they have a choice in the matter. That said, the United States also has what by world standards are very

effective enforcement of its tax laws, and these laws include a requirement that transfer prices correspond to the prices that accurately reflect where income is earned. Reasonable parties, including taxpayers and the IRS, may disagree about the appropriateness of alternative transfer prices, and as a result taxpayers might be under- or over-taxed by the United States relative to what an accurate measurement of U.S. income would dictate.

There is a general sense among observers that, even with its arm's length pricing regime and vigorous IRS enforcement, in practice the U.S. tax base is eroded by the transfer pricing practices of taxpayers whose actions are influenced by the high U.S. tax rate. In part, this sense comes from observation of high-profile tax cases in which the IRS and taxpayers are parties, and in part from an acknowledgment that the inevitably uncertain nature of appropriate transfer prices for certain transactions, and accompanying range of plausible choices, will drive taxpayers to choose transfer prices that favor their tax interests. There are also some widely circulated estimates of aggregate U.S. revenue losses from transfer pricing that come from statistical studies, but I urge the Committee to approach such estimates with a great deal of healthy skepticism.

Evidence of the impact of transfer pricing on U.S. tax collections is surprisingly limited, with many of the widely-quoted figures representing extrapolations from evidence for other countries, which is furthermore based on low-quality data and statistical methods, and models of taxpayer behavior that do not correspond to economic theory. It pains me to say that, since I have done research in this area for more than 20 years, including some of the earliest quantitative transfer pricing studies, and have several times had the occasion to review the international body of quantitative evidence of tax-motivated transfer pricing. This is an area of tax scholarship in which advances in understanding and evidence have not come as rapidly as they have in others.

As a result, the plain fact is that we do not know how much tax revenue the United States may lose each year from transfer price manipulation.

A major problem that statistical transfer pricing studies face is that one does not know how much taxable income would be reported in different jurisdictions in the absence of tax-motivated transfer price adjustments away from the arm's length standard. What analysts often do in this circumstance is to assume that in the absence of any transfer price manipulation all operations of a firm would earn the same return on assets or sales, or in a few cases, return on some other measure of business activity. This assumption is of course wrong, since economic theory does not say that all firms should earn the same average rate of return on sales or assets or anything else. Economic theory does say that, in a perfectly fluid capital market, alternative capital investments should earn the same marginal rate of return, but that is not the same thing as measured average rates of return. This fact is evident if one compares average rates of return (on sales, assets, or anything else) among completely unrelated U.S. companies, where there is no issue of tax-motivated transfer pricing between them since they have different owners, and yet they display widely differing average rates of return, reflecting their different histories and business situations.

The problems confronting existing statistical studies go well beyond the conceptual problem of trying to understand when a reported profit rate might appear to be tax-motivated. The income data used in virtually all studies do not correspond to taxable incomes, nor do the tax data correspond to actual tax payments. It is very difficult even to estimate relevant tax rate differences between countries for the purpose of measuring the extent to which tax rates are correlated with reported profit rates, and most studies wind up using poor proxies for these tax rates.

Despite the commonly acknowledged serious problems that arise in measuring the impact of tax rate differences on reported profit rates, reported intrafirm sales, and other measures related to taxable income, the persistently high levels of reported income in low tax jurisdictions seems to many to be indicative of at least some magnitude of tax-motivated transfer price manipulation. Again, I urge caution in interpreting this evidence, as these profit rates reflect, at least in part, business practices that have nothing to do with transfer pricing. In the ordinary course of events taxpayers have stronger incentives to incur deductible expenses in high tax jurisdictions than they do in low tax jurisdictions. In work undertaken jointly with Mihir Desai and Fritz Foley of Harvard I have found that foreign investments by American multinational firms are financed with significantly more debt in high tax countries than in low tax countries, reflecting the benefits of interest deductions in high tax countries. This pattern holds both for related party debt and for the much larger (in dollar volume) category of unrelated party debt, the latter of course being unaffected by any transfer price manipulation. Interest expenses are more readily identified than are other specific deductible expenses, but presumably the same pattern applies to other expenses for which taxpayers can claim deductions.

Another important issue arises in interpreting the evidence of where income is earned, since in the modern world the income earned by an affiliate of a multinational firm may include income earned by other related parties owned in part or in whole by the affiliates themselves. To take a prominent example, most of the income reported to have been earned in foreign tax havens reflects that multinational firms commonly use tax haven affiliates as conduits for investment in other foreign affiliates; thus, an investment from the United States to France might be routed through Barbados. When the French affiliate remits some of its foreign profits in the form of interest and dividend payments, the income is first received by the Barbados affiliate,

which then pays it to the American parent company in the form of a dividend. International investments use these intermediaries to avoid or defer certain kinds of obligations or restrictions on gross capital flows, such as the stamp taxes, capital gains taxes, and withholding taxes that some countries impose, as well as currency restrictions and capital controls. The indirect ownership structure, which looks suspicious on its surface, is designed to avoid running afoul of foreign restrictions or triggering unnecessary foreign taxes.

Hence much of the income attributed in the data to tax haven operations is in fact income earned by other foreign affiliates in which American parents invest indirectly through tax haven affiliates, and that is somewhat misleadingly reported as tax haven income. This is reflected by the statistics, including the factor of four difference between the tax haven share of the foreign net income of American multinational firms and the tax haven share of value added, the latter importantly excluding various forms of financial income. Uncritical interpretation of the reported income data will inevitably conclude that income levels are far too high in tax havens and other such low-tax jurisdictions, but this interpretation reflects a misunderstanding of what the income data represent: the income figures mostly consist of financial receipts from related parties.

And there are other issues. There is ample evidence that more profitable companies are the most likely to have international operations, and for American firms international operations inevitably mean operations in jurisdictions with tax rates lower than the U.S. rate. It would be a mistake to compare the profit rates of the foreign operations of American firms with the domestic profit rates of American firms generally, as the compositions of these groups differ systematically. In other joint work with Mihir Desai and Fritz Foley we have found that controlling for the identities of parent companies significantly reduces the magnitude of the

measured negative correlation of after-tax profit rates (as a fraction of assets) and local tax rates. Indeed, in that work we found that, for American firms between 1982 and 1997, reported pretax profit rates in high tax locations were no lower, and indeed even a bit higher, than they were elsewhere, controlling for various observable variables, though of course one should be loath to draw inferences from studies attempting to explain income to asset ratios. And there is the mundane problem of publication bias, that estimates of significant tax-motivated transfer price manipulation are more likely to be published than estimates showing the problem to be insignificant.

So where does that leave us? The statistical evidence of the magnitude of tax-motivated income reallocation is highly suspect: in many studies, the apparent effect of tax rates on reported profits simply reflects ordinary business practices. There are informative case studies of individual transactions that appear to use tax-motivated transfer prices, but one never knows how representative these cases are, or for that matter how often governments successfully force taxpayers to declare greater income in high tax locations than they actually earned. It is tempting to select instances of subsequently highly profitable transactions for which a low transfer price was paid from an affiliate in a low tax jurisdiction to a related party in a high tax jurisdiction, but presumably there are also cases of subsequently unprofitable transactions that the authorities in high tax countries do not investigate because it might appear too much tax was paid.

We know from experience that every realm of tax enforcement faces challenges, and the international transfer pricing rules are surely no exception. So there is reason to believe that the United States, with its high corporate tax rate, loses tax revenue from the tax-motivated transfer pricing practices of taxpayers. This revenue loss is obviously not complete, as we and other countries still collect substantial tax revenue from multinational firms; and the evidence that tax

rates significantly influence international investment patterns also implies that taxpayers are unable to manipulate transfer prices to allocate taxable income between countries at will. If it were otherwise – if multinational firms were able to earn money in one place and adjust transfer prices to report all of the income to have been earned elsewhere – then there would be no reason to concentrate productive investments in low tax parts of the world. Since there is ample and convincing evidence that tax rates significantly influence investment patterns, it follows that taxpayers must be significantly limited in their abilities to reallocate income for tax purposes. But that does not imply that taxpayers do not adjust transfer prices to reduce their tax obligations; only that they are limited in their ability to do so.

On net, therefore, it is appropriate to be concerned about the potential for transfer pricing to influence U.S. and foreign tax collections, but there is not any reliable evidence of the magnitude of lost U.S. revenue, and there is ample reason to believe that many studies greatly exaggerate the magnitude of the potential problem.

The Formulary Apportionment Alternative

In reaction to fears about actual or potential tax avoidance under the arm's length pricing standard, there have been numerous calls for stiffer enforcement of the transfer pricing rules, with some expressing doubt that it is possible to craft intercompany pricing rules that can ever succeed. These advocates suggest abandoning altogether the current system of separately accounting for income earned in distinct jurisdictions, replacing it with a system that uses simple formulas to apportion the worldwide income of multinational firms among the jurisdictions in which they have operations. These formulas typically use some combination of employment, sales, and tangible property as implicit indicators of where firms actually earn their incomes.

American states currently use simple formulas to apportion the incomes of multistate businesses within the United States, and, relying on that experience, some suggest that formula apportionment might work well internationally.

In order to adopt a system of formula apportionment it is necessary to specify the weights attached to different factors used to apportion income, and the difficulty of doing so in a sensible way makes vivid at least some of the costs associated with replacing separate accounting with a system of formula apportionment. In the United States, where state governments use formulas to apportion corporate income for tax purposes, states have failed to settle on a common formula. It is far from clear what factors properly enter an apportionment formula – assuming that governments could coordinate on a common formula – if the goal is to allocate income roughly according to where it is earned. Furthermore, the use of formulas to apportion taxable income effectively converts an income tax into a multiple rate tax on the use of the productive factors that enter the formula, with associated loss of efficiency from this haphazard diversity of tax rates. These problems have a common source, which is that profits are not simple scalar functions of employment, sales or tangible property. Instead, profits are produced by many factors, including managerial inputs, that are difficult to measure or subject to reporting manipulation, and therefore omitted from the formulas that governments use. Put simply, the formulas do not apportion income accurately among the jurisdictions in which it is earned.

There is something distasteful and very possibly inequitable about misattributing income for tax purposes, but the associated problems do not stop there, as income misattribution creates incentives for firms to structure their affairs in new ways. Since the formulas apply to affiliates within consolidated groups, it follows that the use of allocation formulas creates incentives to modify the ownership of companies or operations in order to reduce associated tax burdens.

Consider, for example, a profitable American company with income taxed by the United States at a high rate. If the U.S. government required companies for tax purposes to allocate their profits among affiliates using formulas that rely heavily on the location of employment, then the American firm would have a strong incentive to acquire an unprofitable Irish company with a large labor force. In joining the American and Irish operations under common ownership, many of the U.S. profits would be attributed to Ireland for tax purposes, where they would be subject to the much lower Irish corporate tax rate. Conversely, if the Irish company had large profits and the American company did not, then the use of formula apportionment might discourage a merger of the two firms even if the merger would otherwise make sense for business reasons.

In earlier work I have analyzed the nature and magnitude of ownership distortions created by allocation formulas, the extent to which formulas misattribute income when firms merge or divest their operations. Evidence is available from considering the consequences of hypothetical mergers between firms that are currently independent and therefore report their incomes, employment, sales and property separately. Using data from a large sample of European firms, it is clear that mergers among firms, treating two firms for this purpose as though located in different countries, would result in significant reallocations of taxable income, even in the absence of any effect of the mergers on actual operations or profitability.

The formulas used to attribute income between countries can be thought of as forecasts of what fraction of total firm income is likely to have been earned by affiliates with given shares of employment, sales, and property. The statistical analysis in my earlier work analyzes the accuracy of these predictions. The evidence implies that existing formulas fare very poorly from a prediction standpoint, reflecting the inability of sales, employment or property to explain firm profits. Even if one chooses factor weights on sales, employment and property to maximize the

extent to which they account for income, it is impossible to explain more than 22 percent of the variation among firms in their reported profits on the basis of differences in sales, employment, and property combined. The absolute value of prediction errors from a formula based on any combination of employment, sales and property exceeds half of predicted profits 64 percent of the time, and exceeds twice predicted profits 11 percent of the time. Using formula apportionment to assign taxable income to firms is closer to random assignment than it is to something that accurately measures incomes.

One of the costs associated with using formulary apportionment is that these systems create incentives for firms to change their operations through mergers or divestitures. Even in the absence of formula apportionment it is very common for mergers and divestitures to have significant tax effects by triggering the realization of capital gains, changing the ability to offset profits from one operation against losses from another, influencing a firm's ability to claim foreign tax credits, changing asset bases for depreciation purposes, and other tax consequences. There is considerable evidence that tax attributes influence the likelihood and structure of mergers and divestitures, as well as the accompanying transaction prices. Consequently it is reasonable to expect that the ownership incentives created by the adoption of formula apportionment might significantly, and inefficiently, influence patterns of mergers and divestitures.

Formulary alternatives to separate entity accounting hold the undeniable appeal of reducing certain opportunities for tax-motivated international income reallocation. This comes at a serious cost, which is that the factors that enter the formulas do not accurately correspond to the determinants of business incomes. As a result, the formulas misattribute income, so their use in an international setting would misallocate tax revenue among countries and tax burdens

among taxpayers. In so doing, the adoption of formula apportionment creates incentives for new forms of tax avoidance through mergers and divestitures.

Is it sensible to consider formulary alternatives to separate accounting for tax purposes, given the inaccuracy of formulary methods and the incentives they create? Evaluating this question requires a careful comparative examination of all of the unappetizing tax choices that governments face. It is clear from the evidence that formulas attribute income very imperfectly, and create distortionary ownership incentives in the process, so it is difficult to understand why governments that feel they have alternatives would want to embrace such systems of assigning income to taxpayers.

Transfer Pricing Enforcement In a Multi-Country Context

It is by now widely acknowledged that countries including the United States benefit from maintaining competitive tax environments for firms that might want to do business locally. This includes restricting tax rates to competitive levels; but it also includes defining the tax base in a sensible and competitive manner. Countries compete for international business, and those that attempt to overtax this business are apt to lose in international competition, as evidenced by the higher investment rates in lower-tax jurisdictions.

Transfer pricing rules represent one element of tax base definitions over which countries compete in efforts to secure investment, employment, and the economic benefits that go with them. If the United States or any other country were to impose harsh and arbitrary transfer price regulations that burden business operations with unwarranted compliance costs and tax obligations, then we should expect investment to fall as a result – just as any other tax and

regulatory burdens discourage business operations. This is particularly true of investments by multinational firms, which typically have more options than do other companies.

In evaluating potential changes to the transfer pricing rules, therefore, it is important to consider how the United States is positioned relative to other countries that are major capital exporters and importers. It is widely believed that the IRS is without peer in the tax enforcement realm, as reflected in the quality of its operation and the very high overall U.S. tax compliance rate compared to other countries. That, together with the very strict regulations under Section 482 and other Code provisions, puts the United States at the forefront of enforcing international transfer pricing. Of course if there are clear problems with existing rules or enforcement then they should be addressed, but the danger is that efforts to address perceived abuses may include enforcement measures that overtax firms in some or all situations, thereby inefficiently distorting business behavior and discouraging investment.

Consider, for example, the potential use of Subpart F rules to enforce transfer pricing rules, perhaps by deeming certain foreign income to be subject to Subpart F if it appears to have arisen from the use of unwarranted transfer prices. Putting aside for purpose of argument the question of the validity of any particular test of whether transfer prices were appropriate, Subpart F is a difficult enforcement mechanism to use because it applies only to foreign corporations that are controlled by Americans, and not the reverse. Thus, the transfer prices used by a foreign firm that invests in the United States cannot be enforced by Subpart F treatment of the firm's foreign operations, since they are not owned by Americans. Hence widespread use of Subpart F to enforce U.S. transfer pricing rules are apt to be accompanied by foreign acquisitions of U.S. assets, as foreigners would become the tax-preferred owners.

This is just one small example of the importance of maintaining a competitive transfer pricing regime, but it is worth considering the cost of trying to prevent transfer price manipulation in a truly competitive worldwide environment. Suppose, despite evidence to the contrary, that transfer price manipulation were rampant in the world today, and that despite the best efforts of the IRS this problem afflicted the United States, reducing U.S. tax revenues as firms reallocated taxable income to lower tax jurisdictions. Suppose that the U.S. government were to implement a simple and cost-effective fix for the problem – whatever that fix might be. Then the result would be that business operations in the United States would effectively be taxed at higher rates than they were prior to the introduction of the fix – that, after all, would be the whole idea. If this really were the situation, then it would be in the interest of the United States to adopt such a fix, but in doing so to be mindful of the need to maintain a competitive environment for new and existing businesses, given that other countries would not have the same enforcement regime as the United States. Transfer price solutions that entail greater tax obligations on someone's part come at a cost, particularly given the mobility of international business operations.

Moving from that rather fanciful hypothetical to the world in which we live, it is important to understand U.S. transfer price enforcement in the context of competing nations, and to appreciate that any efforts we make now or in the future are apt to influence the competitive position of the United States. Many potential reforms to U.S. tax rules that wrest greater tax revenue from international investors in an inefficient manner would, if unaccompanied by other changes, distort the pattern of business ownership and further reduce business activity in the United States. Taxpayers should certainly pay the taxes they owe, and the current separate accounting system with arm's length pricing is the appropriate standard by which to judge tax

obligations. With greater resources the IRS could undoubtedly do an even better job of enforcing our transfer pricing rules, but in any case panic is unwarranted, and likewise unwarranted are other broad reforms such as the introduction of formula apportionment or other arbitrary deviations from the arm's length standard.