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Hearing on "Transfer Pricing Issues in the Global Economy"

Good afternoon, Chairman Levin, Ranking Member Camp, and other members of the Committee. Thank you for this opportunity to share my views on transfer pricing, a critically important issue in corporate tax policy and for the practitioner community.[2] My testimony will address the magnitude of the transfer pricing problem, its detrimental impact on the economy, and the need for congressional action to overhaul rules for apportioning profits of global businesses.

I. Scope of the Problem

In addition to anecdotal evidence from practitioners, and the revelations from court cases, economic data from a variety of sources indicate inappropriate profit shifting occurring on a large scale. By "inappropriate" I mean the perfectly legal but economically indefensible assignment of profits to subsidiaries in low-tax jurisdictions.

A. In General

The adjacent table presents the latest data on the profitability of affiliates of U.S. multinational corporations in five low-tax countries. In all these jurisdictions the average effective tax rate of U.S. affiliates was below 10 percent. Although these are all small jurisdiction (with their economies equal to only about 5 percent of the European economy) they together account for 24 percent of foreign profits of U.S. multinationals. There is no perfect way to measure profitability, but by almost every measure these five tax havens have extraordinarily high rates of profit. These figures strongly suggest U.S. multinationals are readily able to shift profits into tax havens and thereby significantly reduce taxes properly owed to the United States and other industrialized nations.[3]

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[1] The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

[2] "Recent surveys show that multinational enterprises rank transfer pricing as their single most important international tax issue and I am sure that a survey of governments would yield the same results." Jeffery Owens, speech at OECD Conference: "Transfer Pricing and Treaties in a Changing World" September 21-22, 2009.

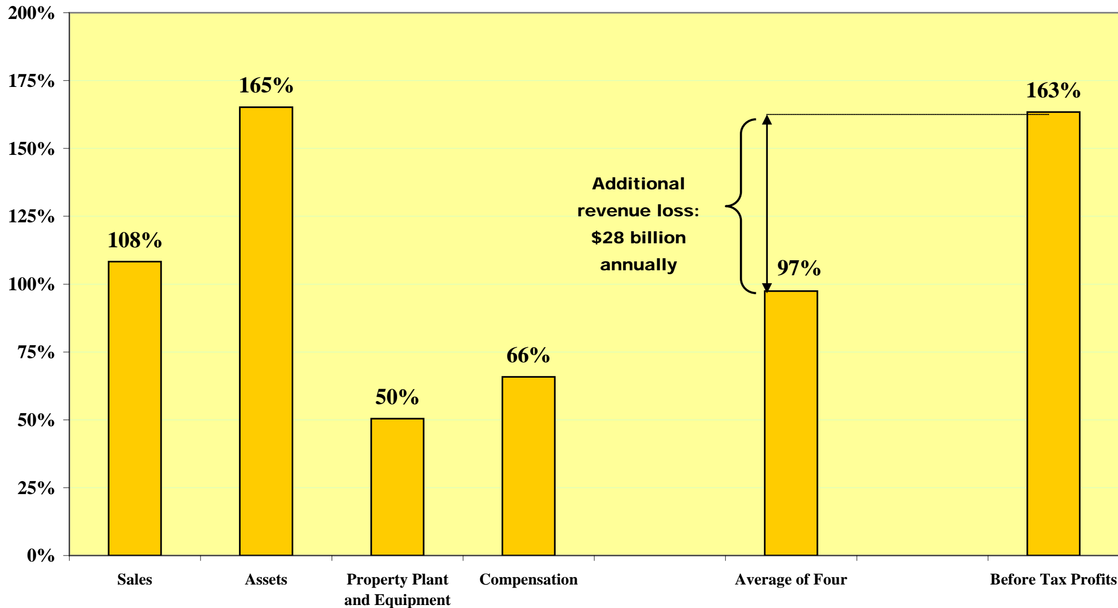
[3] These finding are consistent with other studies that find an inverse relationship between the profitability of foreign subsidiaries and foreign tax rates. See, Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, pp. 55-61.

Profits and Profitability of Foreign Affiliates of U.S. Multinationals in 2007						
	Before-tax Profits (millions)	**Effective Tax Rate**	**Profit as % of Sales**	**Profit as % of Property**	**Profit as a % Employee Compensation**	**Profit per Employee**
Bermuda	$ 16,213	2.6%	21%	272%	7174%	$ 5,404,333
Singapore	$ 14,624	7.4%	6%	125%	277%	$ 115,422
Ireland	$ 45,403	7.7%	20%	170%	724%	$ 488,730
Switzerland	$ 18,195	9.1%	7%	164%	228%	$ 219,217
Cayman Islands	$ 7,414	9.4%	24%	218%	2415%	$ 1,123,333
Five Tax Haven Total	**$ 101,849**	**7.2%**	**12.2%**	**173%**	**508%**	**$ 326,230**
Worldwide Total	**$ 430,186**	**29.6%**	**9%**	**44%**	**101%**	**$ 42,947**

Source: Author's calculations using latest data from the Bureau of Economic Analysis of the U.S. Department of Commerce. The BEA data does not include banks and other financial businesses.

Over the last decade the transfer pricing problem has gone from bad to worse. Figure 1 shows that the degree of income shifting out of the United States has risen. From 1999 through 2007 foreign profits of U.S. multinationals have increased by 163 percent while over the same period traditional indicators of economic activity have increased on average by only 97 percent. This excessive growth of foreign profits represents an annual revenue loss of $28 billion over and above the revenue loss if transfer pricing rules were as effective as they were in 1999. This is a lower bound estimate of the total annual revenue loss from inappropriate transfer pricing and income shifting.[4]

Figure 1. Growth of Foreign Affiliates of U.S. Corporations Between 1999 and 2007



Source: Martin A. Sullivan, "Transfer Pricing Costs U.S. at Least $28 billion, *Tax Notes*, March 29, 2010. Underlying data are from the Bureau of Economic of Economic Analysis of the U.S. Department of Commerce.

[4] The total annual U.S. revenue loss is probably significant larger than $28 billion because (1) the data used in this estimate exclude financial corporations and (2) this estimate only accounts for increased revenue loss since 1999, and by all accounts there was already a significant transfer pricing problem in 1999. On this last point see, for example, James Hines and Eric Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics*, February 1994.

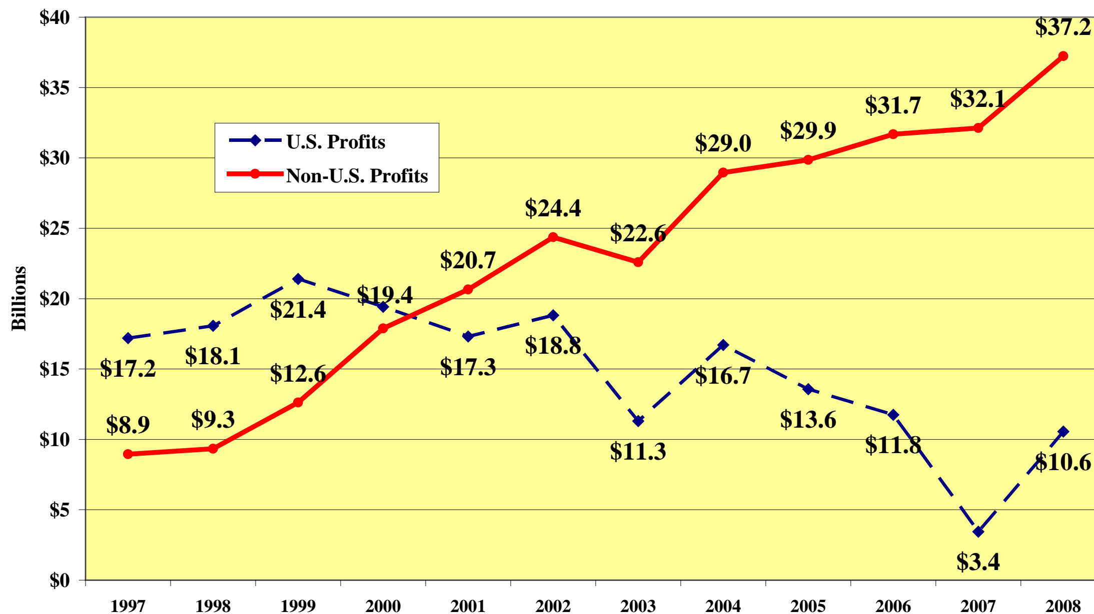
Annual report data from 80 of America's largest corporations show that in the short time between the 1997-99 and 2004-06 periods the average effective tax reported to shareholders declined by approximately four full percentage points.[5] Three-quarters of this decline was attributable to increasingly favorable tax treatment of foreign activity.[6] Falling foreign tax rates and an increase in real economic activity in jurisdictions with lower rates explain some of this decline, but not all. These findings point to transfer pricing as an important contributor in the decline of effective tax rates multinational companies report to their shareholders.[7]

B. Example: The Pharmaceutical Industry

Pharmaceutical companies are especially well positioned to take advantage of inadequate transfer pricing rules. Intangibles are particularly problematic using current methods,[8] and in the pharmaceutical business drug patents and marketing intangibles are of paramount importance.[9]

Figure 2a shows a tremendous shift in profits from the United States to foreign jurisdictions by U.S. pharmaceutical companies over the last dozen years. Figure 2b shows that their foreign subsidiaries' share of profits far exceeds their foreign subsidiaries' share of sales and assets. As shown in Figure 2c, this has allowed U.S. pharmaceutical companies to reduce their effective tax rate on average by nine percentage points between the 1995-97 and 2006-08 periods.

Figure 2a. Foreign and Domestic Profits of Seven Large U.S. Drug Companies, 1997-2008



Source: Annual reports of Merck, Abbott, Johnson & Johnson, Bristol-Meyers Squibb, Pfizer, Schering-Plough, and Eli Lilly. Wyeth and Amgen excluded due to incomplete data in early years.

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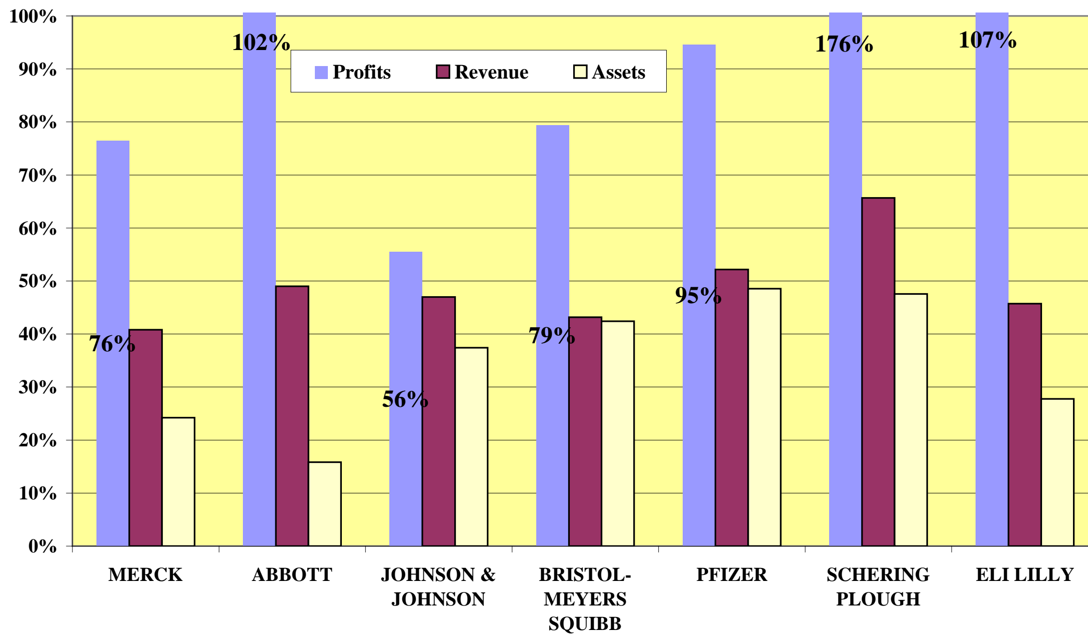
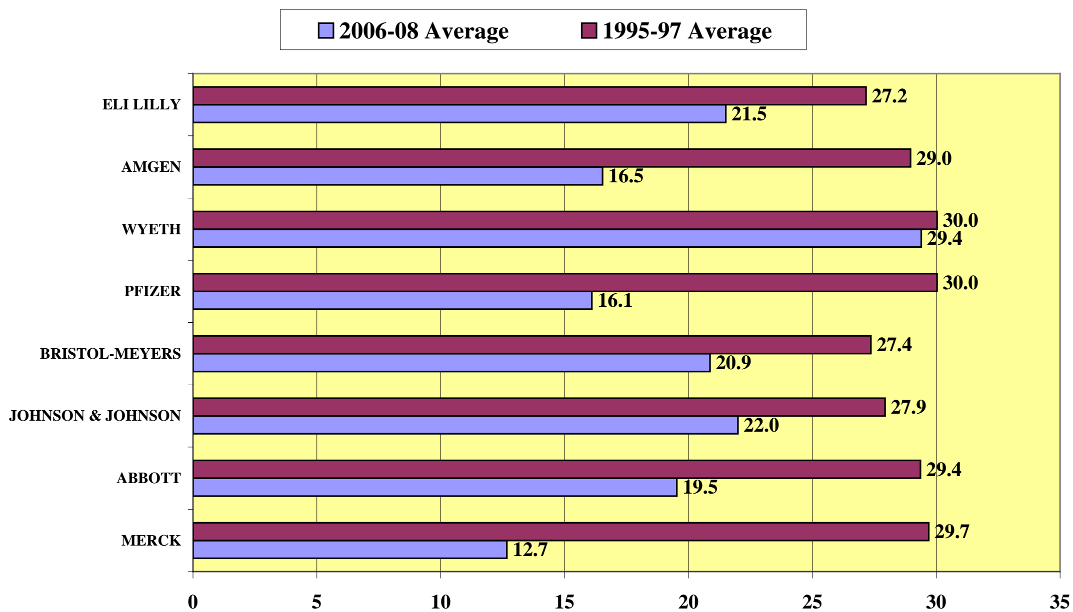
[5] Martin A. Sullivan, "Reported Corporate Effective Tax Rates Down Since Late 1990s," *Tax Notes*, Feb. 25, 2010.
[6] Martin A. Sullivan, "Why Reported Effective Corporate Tax Rates Are Falling," *Tax Notes*, March 3, 2008.
[7] Martin A. Sullivan, "U.S. Multinationals Paying Less Foreign Tax," *Tax Notes*, March 17, 2008.
[8] "[T]here is significant risk of income shifting from transfers of valuable intellectual property that are crucial to the core business of a taxpayer and that are difficult to value accurately. (Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, p. 54)
[9] Martin A. Sullivan, "Drug Company Profits Shift Out of United States," *Tax Notes*, March 8, 2010.

Figure 2b. Drug Company Foreign Shares of Profit, Sales, and Assets, 2006-2008



Source: Company annual reports.

Figure 2c. Effective Tax Rates of Large U.S. Drug Companies: 1995-97 and 2006-08 Compared



Source: Companies' annual reports. Schering-Plough not included because losses in later years make effective tax rates not meaningful.

II. Should We Care?

These data demonstrate that aggressive transfer pricing results in significant revenue losses for the U.S. Treasury. This is a problem now more than ever as the United States stands at the abyss of an unprecedented fiscal crisis. To attain the President's modest goal of putting the government's finances on a sustainable path by 2015—that's not balancing the budget, that's just getting the deficit down to 3 percent of GDP—will require a combination of spending cuts and tax increases of approximately $500 billion per year![10]

A. Basic Economics: Neutrality

But the transfer pricing problem is about more than large revenue losses. The detrimental effects of aggressive transfer pricing on economic incentives has not received enough attention in the policy debate. **The tax benefits that result from inappropriate income shifting drive effective tax rates to extremely low and negative levels**. These effective tax rates violate all our notions of neutrality and fairness. Aggressive transfer pricing provides tax subsidies that not only advantage foreign over domestic investment by U.S. multinationals, but that also advantage foreign investment by U.S. multinationals over investment by foreign competitors in their local markets.

Economists put tremendous emphasis on neutrality because by equalizing tax rates the tax system can most closely align itself with the efficiency of the free market. With respect to investment, neutrality means equalizing effective tax rates to keep government from interfering with business decisions about the allocation of capital.

In the international arena this concept has become muddled because it is unclear whether the effective tax rate on foreign investment by a domestic corporation should equal the domestic tax rate or the foreign tax rate. The equalizing of tax rates of domestic and foreign investment by a domestic corporation is known as capital export neutrality (CEN). Equalizing the effective tax rate on investment in a location regardless of the residence of the investing corporation is known as capital import neutrality (CIN). Under CEN U.S. multinationals would pay a 35 percent tax on profits in Ireland. Under CIN they would pay 12.5 percent.

CEN is the principal behind the sweeping international tax reforms originally proposed by the Kennedy Administration in 1962. And it is the fundamental idea behind the international tax proposals now put forward by the Obama Administration. By raising effective tax rates on foreign investment, proposals that limit deferral tend to move United States in the direction of CEN. Proponents of CEN argue that without equalizing taxes paid on foreign and domestic investment by U.S. multinational corporations, those corporations will have a significant incentive to move jobs offshore.

CIN is the justification for a restructuring of the U.S. tax rules from a system of worldwide taxation, where U.S. tax is imposed on all domestic and foreign profits, to an exemption or "territorial" system, where foreign profits are exempt from U.S. tax.[11]

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[10] Martin A. Sullivan, "Deficit Commission: How Big Will the Tax Hikes Be?" *Tax Notes*, March 1, 2010. New estimates from the Congressional Budget Office imply an even larger amount of deficit reduction will be required to put the federal debt on a sustainable path. See, CBO, "The Long-Term Budget Outlook," June 2010, p. 14.

[11] In general, the business community does not support the United States switching from a worldwide system to an exemption system. See, Judy Scarabello, "NFTC Refutes Benefits of Territorial Tax System," National Foreign Trade Council press release, May 5, 2004. As noted by the Joint Committee on Taxation, current law in general is more

There is huge, unresolved policy debate about the relative merits of CEN and CIN. The main point here is that **aggressive transfer pricing is not defensible under either CEN or CIN.** Transfer pricing drives foreign effective tax rates below both the U.S. rate and the rate paid by foreign taxpayers. Moreover, with aggressive transfer pricing it is commonplace for effective tax rates on foreign investment to drop below zero. (This means the United State is not taxing but subsidizing foreign investment.) This occurs because in many cases the United States is not only leaving foreign profits untaxed but it is also allowing U.S.-source income to escape U.S. tax.

Here is a simple but relevant example. Suppose a U.S. multinational has a foreign manufacturing and distribution subsidiary in Ireland. Suppose that for a nominal fee the U.S. parent company allows the Irish subsidiary to use valuable marketing and manufacturing intangibles. Without access to these intangible the Irish subsidiary would only have $100 of profits. $100 is the true economic income attributable to the activities in Ireland. Access to the parent company's intangibles allows the Irish subsidiary to book $300 of profit. The Irish subsidiary should be paying the U.S. parent $200 in royalties (or its equivalent) but because of lax transfer pricing rules it does not.

The corporate tax rate in Ireland is 12.5 percent, so Irish tax liability in this example is $37.50. The shift of $200 of profits out of the United States reduces U.S. taxes by $70. The total net tax on the Irish investment is minus $32.50 on $100 of economic income. The effective tax rate is negative 32.5 percent. This is far below the 35-percent rate paid by purely domestic U.S. corporations on their profits and far below what Irish corporations pay on income from their domestic operations. Both CEN and CIN are violated.

B. Beyond Neutrality: Is There a Case for Subsidies?

There is a widely held but not well thought out notion that any proposal or planning that reduces tax on foreign investment improves multinationals' "competitiveness." Of course, in a narrow sense this is true. Tax breaks, cash payments, and subsidies of any kind made available to multinationals make them more profitable, and some of that benefit should translate into increased ability to compete in international markets.

But as a general matter there are only limited circumstances where providing advantages to some taxpayers and not to others is economically justified. These cases most often involve what economists call "positive externalities." This phenomenon occurs when a business activity provides a benefit to society that is not all translated into profit for the business bearing the expense.

The classic example, and the example that is relevant here, is research and development. A business that undertakes research discovers new knowledge for its own use, but there may also be spillover benefits to other businesses and to society as a whole. Without subsidies there will be underinvestment in research from society's point of view. This is the primary economic justification for patents and for research tax credits. (Note that there is not much of an externality argument for the development of marketing intangibles—like trademarks—that are also a large component of current transfer pricing disputes.)

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generous than an exemption system: '[I]n many cases, the present-law "worldwide" system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the "territorial" exemption systems used by many U.S. trading partners.' (*Options to Improve Compliance and Reform Tax Expenditures*, Jan. 27, 2005, JCS-02-05, p. 189.) The JCT estimates that its proposal for an exemption system would *raise* revenue compared to current law.

The argument is often made that without favorable tax treatment in foreign markets U.S. corporations will not be able to exploit research to its fullest. In other words, research is more valuable when its fixed costs can be spread over a larger volume of sales. There is no denying the logical flow of this statement, but by itself it falls far short of a compelling policy justification for lax enforcement of transfer pricing rules.

To justify lax transfer pricing as an incentive for research requires demonstrating in fact and not just in theory that tax rules have a major impact on the location of distribution subsidiaries, that the amount of research conducted is responsive to the size of the market, and that licensing to a third party is not a viable alternative. In any case, special tax benefits for some (i.e., low-tax foreign) markets is an indirect and an inefficient method of subsidizing domestic research. Much of the profit that is provided favorable tax treatment under lax transfer pricing rules has no relation to publicly beneficial research. Conversely, much of the profit from beneficial research (e.g., domestic profits) does not receive any tax benefit. Rather than providing haphazard tax relief for some profits of some research, a far superior and simpler policy would be to expand subsidization of the domestic research expenditures if the magnitude of those subsidies is not already sufficient.

Another argument for allowing U.S. multinationals to shift profit into tax havens is that they must compete with foreign multinationals that can shift profit into tax havens. In other words, a U.S. multinational may be competing for business in foreign country X not only with competitors based in country X but also with a multinational based in a third country Y. If country Y allows its multinationals to reduce taxes through profit shifting, then so should the United States. According to this view, effective tax rates below standard foreign rates (and often below zero)—which violate both CEN and CIN—are justified.

In response to this argument it must be noted that even though our major trading partners have adopted exemption systems (which appear more favorable than the U.S. worldwide system) it is not at all clear that their transfer pricing rules and their controlled foreign corporation rules are less stringent than U.S. rules.[12] So, in fact, non-U.S. multinationals may not have greater opportunity for aggressive profit shifting than U.S. multinationals.

But even in cases where it is true that foreign rules are more generous than U.S. rules, the correct policy response is not to match that subsidy. Unless there is a significant externality benefit, any country providing subsidies is imposing self-inflicted wounds on its own economy because the cost of the subsidy will be greater than any economic benefit. As when similar issues arise in trade policy, the United States should provide leadership in multinational forums and challenge unjustified subsidies.

[12] Paul Oosterhuis made this point in his June 22, 2006 testimony to the Ways and Means Subcommittee on Select Revenue Measures: “The implication of the principle articulated [by proponents of U.S. tax relief for foreign source income] that our CFC rules should be in line with those in major foreign countries is that we need not have our CFC rules be more lenient than the comparable rules found in these major foreign countries. In my experience at least, the kinds of earnings stripping transactions that check-the-box planning and the newly enacted related party look-through rules permit are substantially more difficult to accomplish, and are thus less frequently undertaken, by French, German, Japanese, and U.K. multinationals because the CFC rules in those countries tax such transactions in most cases.”

III. What Can Congress Do?

A. Do Not Rely on Revised IRS Regulations

Over the decades hard-working and highly skilled IRS and the Treasury Department officials assigned to transfer pricing have had to contend with intense political pressure, unfavorable court decisions, and—most of all—a fundamentally flawed framework that gives primacy to the arm's length standard. These factors have made it impossible to write regulations that can stem the tide of inappropriate transfer pricing.

B. Reduce the Corporate Tax Rate

Over the last two decades statutory corporate tax rates around the world have steadily declined while the U.S. rate has actually increased. Even in the face of enormous budget deficits Japan's government is now considering corporate rate reduction.[13] This would leave the United States with the highest statutory corporate tax rate in the world. Cutting the corporate tax rate would improve the competitiveness of all U.S. corporations—both purely domestic and multinational—and it would reduce incentives for income shifting by reducing the differential between foreign and domestic tax rates. Revenue reductions from small rate reductions (e.g., 5 percentage points) could be offset with base broadening measures.[14] Large rate reductions (e.g., more than 15 percentage points) probably would only be possible as part of a major tax reform that included a new consumption tax.[15]

C. Elevate the Status of Formulary Methods

To make a real dent in the transfer pricing problem Congress must go beyond the usual mild remedies, such as increasing penalties, requiring more disclosure, and urging more enforcement.[16] There is a lot of truth to the claim that on transfer pricing issues the IRS is repeatedly outflanked by an army of private-sector lawyers and economists. But the bigger problem is the body of law the agency must work with.[17] The statutes and regulations enshrine the arm's length standard. This standard gives primacy to the often futile search for comparable unrelated-party transactions in the hope of using those transactions to determine the terms for related-party transactions.

The arm's length method is seriously flawed in both theory and practice. The theoretical problem is that because of synergies within a large corporations—what economists call "economies of scope"—the economic relationship between entities within a corporate group are not the same as

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[13] Randall Jackson, "Japan Looking to Cut Corporate Tax Rate," *Tax Notes International*, June 28, 2010.

[14] Martin A. Sullivan, "Hey, Corporate America, Wanna Make a Deal?" *Tax Notes*, May 12, 2008.

[15] Martin A. Sullivan, "Business Should Lead on Deficit Control and Tax Reform" *Tax Notes*, July 5, 2010.

[16] The Clinton campaign in 1992 promised to crack down on transfer pricing abuse. And it floated the figure of $7 billion (about $15 billion in today's terms) as the amount of annual revenue that could be raised. In the end the only legislative action taken was passage of a "transfer pricing initiative" (increasing penalties and documentation requirements) that was estimated to raise less than $100 million annually.

[17] "The problem is in the law, not in those who have tried to conduct international business under it or to enforce it." Michael C. Durst, "A Statutory Proposal for U.S. Transfer Pricing Reform," *Tax Notes International*, June 4, 2007.

those between parties.[18] The practical problem is the lack of truly comparable unrelated transactions that can be used to apply the arm's-length method to related party transactions.[19]

As manufacturing and the importance of national borders shrink, cross-border transfers of valuable intellectual property within a single multinational are becoming increasingly common. Unfortunately, this is the type of transfer pricing issue that poses the greatest challenge to the arm's-length method. The simple reason is that intangibles by their nature are unique, and so it is always difficult, and frequently impossible, to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Administering the arm's-length method without comparables is like playing hockey without a puck.

Modifying the arm's length standard will not get the job done.[20] The only credible long-term solution is the defenestration of the arm's length standard and its replacement with formulary apportionment methods.

I believe the shortcomings of the arm's length standard could be made crystal clear to this Committee if it would undertake a thorough review of the IRS Advance Pricing Agreement Program. Such a study was undertaken by the Senate Committee on Finance.[21] Reportedly the staff's extensive research led to many unfavorable conclusions about the APA program, but the final report was never released.[22]

The major alternative to the arm's length method for allocating income to locations is formulary apportionment. It is used by the U.S. states and by provinces in Canada. It is under consideration in the European Union (but it is unlikely to receive the approval of all 27 member states). Under formulary methods, the worldwide profits of a multinational business are allocated in proportion to some combination of observable factors like sales, employment, and tangible property.

The major problem with a pure formulary approach is international coordination (including a lot of renegotiation of existing tax treaties). The major benefit would be the elimination of profit accumulation in tax havens with little or no real economic activity.

Although proponents of the arm's-length method hate to admit it, there are some formulary elements employed in current law.[23] Profit-split methods widely used for allocating income from intangibles are a crude version of a formulary method.

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[18] Synergies in production, distribution, and risk-bearing are an economic explanation of why multinationals exist instead of a myriad of smaller companies buying and selling specialized products and services from each other.

[19] The only good opportunity for using comparables for determining royalties for related-party intangibles is when the multinational have licensed the same intangible to an unrelated party in another geographic market. But even under these fortunate circumstances, the degree of comparability can be unsatisfactory because of market differences. For example, the per-unit profitability of a rice cooker employing a new technology may be different in Asia than in Europe.

[20] "To date, the JCT Staff is unaware of any comprehensive proposal to modify the arm's-length pricing rules in a manner that would ensure their effectiveness." (Joint Committee on Taxation, "Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment," June 25, 2008, JCS-55-08.)

[21] "Grassley, Baucus Launch Review of Whether Certain Multinationals Pay Fair Share of Taxes," December 22, 2003 press release from the Senate Committee on Finance.

[22] Lee A. Sheppard, "Draft Senate Finance APA Report Shows Incompetent IRS." *Tax Notes International*, June 27, 2005; and Lisa M. Nadal, "Who Killed the Senate APA Report?" *Tax Notes International*, Jan. 21, 2008.

[23] Martin A. Sullivan, "A Middle Path between the Arm's Length and Formulary Methods," *Tax Notes*, Jan. 18, 2010; and Lee. A. Sheppard, "Stress Testing Transfer Pricing," *Tax Notes International*, March 16, 2009,

A proposal by Reuven Avi-Yonah, Kimberly Clausing and Michael Durst for system that uses a "formula-based profit split" is an excellent starting point for congressional consideration of a formulary approach. Under this method, U.S. profits would be determined in a two-step process. First, a fixed markup would be applied to U.S. expenses. (This is a relatively simple and widely used method under current law.) Second, after applying similar markups to affiliates in other jurisdictions, all residual profit would be allocated in proportion to sales in each jurisdiction.[24]

D. Strengthen CFC Rules as Proposed by the Obama Administration

Short of codifying formulary approaches, there are some lesser but potentially helpful steps Congress can take to reduce inappropriate income shifting. The use of anti-deferral rules (usually referred to as "Subpart F rules" in the United States or "controlled foreign corporation rules" in the rest of the world) as a backstop to the transfer pricing rules is long-established and widely-used.

There is no disagreement about the need for passive income to be subject to anti-deferral rules. (Otherwise, U.S. taxpayers could shift assets to tax haven corporations and pay no tax on income from those assets.) The issue is what, if any, foreign active business income should be subject to immediate U.S. tax. In 1962 Congress recognized that certain situations were highly susceptible to transfer pricing abuse. At that time, when most real business activities of U.S. multinationals took place in high-tax countries, the establishment of "base companies" in low-tax jurisdictions and the transfer of profits through related-party transactions to these base companies provided significant tax savings. To take the tax benefit out of these transaction Congress subjected base company income to immediate taxation under Subpart F. (These rules are now largely obsolete because of "check-the-box" rules.)

Other major industrialized countries, most of whom have exemption systems, have anti-abuse rules that revoke the exemption privilege not only for passive income but also for active income where there is potential for transfer pricing abuse that threatens the domestic tax base. The rules vary widely and are highly complex. These rules struggle to maintain a balance between competitiveness (by providing a full exemption for properly measured foreign source income) and preventing tax avoidance (by preventing shifting of domestic income to tax havens).

In trying to identify situations where transfer pricing abuse is likely, these rules look at a number of factors. High on the list is the favorability of the tax system of the jurisdiction in which the foreign subsidiary operates. Some countries form "white lists" of jurisdictions that have sufficiently high levels of taxation or have treaties with the home country. Subsidiaries operating in white list countries automatically qualify for exemption or face less stringent anti-avoidance rules. Other countries have created "black lists" of tax havens where exemption is not permitted or is much more difficult to obtain. Still another method is to determine the effective tax rate of a subsidiary and only allow exemption if it exceeds some threshold (for example, 25 percent in Japan and 21 percent in the United Kingdom[25]). In addition to low tax rates, other factors that could trigger anti-avoidance treatment are lack of commercial activity or lack of local management and control in a subsidiary in a low-tax jurisdiction.

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[24] Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review*, 2009.

[25] The Japanese government is currently considering reducing the threshold to 20 percent. The United Kingdom is currently undertaking a comprehensive review of its CFC rules.

In its latest budget the Obama Administration has proposed creating a new category of subpart F income. Under the proposal, the profits subject to Subpart F inclusion must be (1) from an intangible, (2) from a subsidiary paying low foreign taxes (suggested by the Treasury to be less than 10 percent), *and* (3) earning an excessive return (suggested by Treasury to be above 30 percent). All three of these characteristics are commonly found in inappropriate transfer pricing. **The Obama proposal is in line with well-established practice of using CFC/Subpart F rules as a backstop to transfer pricing rules.** As such, if it is properly designed it would be an important additional tool for IRS efforts to combat transfer pricing abuse.

E. A Minimum Tax on Foreign Profits

As with all CFC/Subpart F rules, the Obama administration's proposal is extremely complex. The main difficulty is finding that elusive dividing line between real income from business activity and tainted income from tax-motivated profit shifting.

I believe the administration's proposal is too cautious. It targets the low hanging fruit (i.e., profits that are from low-tax countries *and* are from intangibles *and* are "excessive.") This is particularly worrisome as it is usually the case that revenue raising provisions are weakened as they wind through the legislative process. The worst outcome would be a much watered-down provision that in most cases could be avoided with tax planning. This would only be a fig leaf on the transfer pricing problem, and by giving the appearance of decisive action, it would only further delay real reform.

I have proposed a 10-percent minimum tax on foreign earnings.[26] The proposal is a simplified alternative to the Obama plan. Unlike the Obama proposal all suspect earnings would be subject to a new 10 percent minimum tax (instead of the 35 percent statutory rate). While the penalty rate is lower, the net is cast wider than under the Obama plan. Under the proposed minimum tax, there would be no difference between the treatment of intangible and other types of income (an often impossible distinction to make). And there would be no need for an arbitrary determination of "excessive profits." Under this plan all foreign income would be required to pay at least 10 percent tax. If the foreign rate is less than 10 percent, the new U.S. tax would make up the difference.

This proposal would limit the allure of zero-tax havens and (hopefully along with cut in the U.S. corporate rate) reduce the incentive for income shifting. At the same time the low 10 percent rate would not be a significant impediment to the competitiveness of U.S. multinationals in overseas markets.

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Thank you for this opportunity to share my views.

[26] Martin A. Sullivan, "Should the U.S. Limit 'Excessive' Returns in Low-Tax Countries?" *Tax Notes*, March 15, 2010.