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Testimony Before the House Committee on Ways and Means

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It is my pleasure to appear before you to discuss certain issues relating to corporate profit shifting and tax base erosion under current United States income tax rules. I am appearing on my own behalf, and not on behalf of any client or organization. As such, the views I express here today are solely my own.

I. Introduction

A series of recent events – including the recent hearings held by the Senate's Permanent Subcommittee on Investigations regarding "Offshore Profit Shifting and the U.S. Tax Code," the OECD's ongoing project regarding base erosion and profit shifting (the "BEPS" project), and hearings held in the U.K. parliament regarding the taxation of multinational corporations – have brought to light concerns about the taxation of multinational corporations. The focus of these events has been on the ability of multinational corporations to locate their profits in low-tax jurisdictions through intercompany transactions and thereby minimize their worldwide effective tax rate.

In the recent PSI hearing regarding Apple's tax structure, much of the focus was on the taxation of Apple's income that is attributable to its non-U.S. sales. As was disclosed in the hearing, that income is largely earned by Irish-incorporated – though not Irish tax resident – affiliates of Apple that are party to a cost-sharing arrangement under which they fund the development of and own the rights to intangible property that is used in Apple products sold outside the United States. The large profits earned by these entities – combined with the minimal tax they paid – has led to increased criticism of multinational corporate "profit shifting" generally, and more specifically has caused some to question the validity of cost sharing arrangements as a means of allocating income and expenses within a multinational corporate group. I question whether that is the right lesson to learn from the recent PSI hearings; a number of cautionary points should be considered when assessing the scope of the profit shifting problem and the wisdom of any proposed solutions.

II. Distinguishing Income from U.S. and Foreign Sales

When discussing the problem of profit shifting and base erosion the first question that must be asked is: whose tax base is being eroded? From a U.S. perspective, the answer to this question is particularly thorny in the context of sales of products outside the United States. Does the profit from those sales properly belong in the United States, or should it be subject to taxation in the first instance in a foreign country, i.e., the “market,” “destination,” or “source” country where the good is sold? Where product development activities occur in one country – say, the United States – the funding for that development occurs in another – perhaps an Irish affiliate – and the sale occurs in yet a third country – for example, the United Kingdom – it is not remotely clear that the bulk of the income from that ultimate non-U.S. sale is properly allocable to the United States such that the income can be said to have been inappropriately “shifted” outside the United States if it is reported as earned elsewhere. This is particularly true for consumer products where much of the value lies in consumer preferences and brand awareness, both items of value that typically inhere in the market country and not in the location of product development activities or in the parent’s country of residence.

Indeed, much of the recent criticism of multinational corporate tax practices in the U.K. has focused on precisely this point. U.K. officials, in their criticism of the tax practices of U.S. multinationals like Amazon, Starbucks, and Google – the three companies that were the focus of the U.K. inquiry – complained that these companies all make substantial income on their sales to U.K. consumers and yet pay little to no U.K. corporate tax. Implicitly or explicitly, these U.K. officials were taking the position that it is the market country – i.e., the location of sales – that should drive the determination of the location of income, and not the place of product development or funding. To the extent multinational companies employ strategies to minimize their U.S. taxable income on foreign sales, it is not clear that income has been "shifted" outside of the United States because it is not clear that that income "belonged" to the United States in the first instance. Certainly the recent hearings in the U.K. indicate that there is no international consensus regarding the proper allocation of such income.

Other countries, including most prominently China and India, two of the fastest growing market countries in the world, maintain a strongly held view that all intangible profit should be taxed in the market country. They argue that because it is their laws that protect the value of intellectual property in transactions with consumers in their country, the income resulting from those transactions is properly taxed there. While their view is obviously not universally accepted, it is consistent with the long-standing U.S. source rule for income from intangible property in the U.S. and the source rules of most other developed countries, which source the income where the intangible property is "used." The United States would thus likely face strong headwinds in any effort to assert that the location of product development activities should determine the right to tax income.

Whatever position the United States takes, one needs to be consistent. If the United States wants to take the position that income allocation depends on the location of product development activities rather than its place of sale, it must do so no less with foreign-developed and imported products than with U.S.-developed products. Take, for example, the case of the U.K.-developed drug that is sold in the United States. If we assume that income from a U.S.-developed, but foreign sold, Apple product is properly allocable to the United States, we would have to concede that the U.K. company's income from U.S. pharmaceutical sales properly belongs to the U.K. But that was not the position taken by the Internal Revenue Service in its transfer pricing dispute with Glaxo SmithKline regarding income from the sale of products that were developed in the U.K but sold in the United States. In that case, the IRS took the position that approximately 85% of the profit from the sale of pharmaceutical products in the United States was properly allocable to the United States based on the value inherent in the U.S. market, and that only 15% was attributable to the jurisdictions outside the U.S. which developed, funded and owned most of the product intangibles (i.e., patents), and manufactured the product. According to the IRS the case was settled with the Service getting 60 percent of the amount at issue.[1] If this is correct, then over half of the income from the products sold in the United States was taxed in the United States.

We cannot have it both ways. We cannot ascribe the majority of the value to the market country when we are the market country and to the developing country when we are the developing country. We must therefore be careful in attaching the profit shifting or base erosion label to income that, when fully thought through, we ought not assert is ours to tax in the first instance.

III. Foreign Taxation of Income From Foreign Sales

If there is some merit to the above discussion, and therefore at least some basis for assuming that the market country has a primary claim to tax the income from sales in that

1 The IRS press release announcing the settlement can be found at http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute.

country, the question then becomes should the United States care whether or how much tax is actually charged by or paid to the market country. Put differently, if U.S. multinationals are minimizing foreign taxes on their foreign sales by shifting income from the U.K. to Ireland, is that a "bad" thing from our perspective?

Returning to the examples of Starbucks, Amazon, and Google – the companies that were the focus of the inquiries in the U.K. – all of them were earning income from their U.K. sales in jurisdictions outside the U.K. – Ireland, Luxembourg, and the Netherlands. As a result, they paid minimal U.K. tax – and presumably minimal foreign taxes generally – on that income. But if that income is not the United States' to tax, why should we – rather than the U.K. tax authorities – worry if those companies are employing strategies to minimize their U.K. taxes?

Indeed, that was the position taken in the past when, for example, Congress put the brakes on Treasury and the IRS's efforts to write regulations that would limit the use of the check-the-box rules to achieve foreign tax minimization. When the IRS announced its intent to write such rules in Notice 98-11, the negative reaction was widespread and the effort was abandoned in the face of congressional scrutiny.[2] And thereafter Congress effectively codified the permissibility of foreign-tax minimization through its enactment of the (temporary though perennially extended) look-through rules of section 954(c)(6), whose primary purpose is to allow multinational corporations to achieve foreign tax minimization without triggering an immediate resulting U.S. tax liability.[3]

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2 *See* Notice 98-35, 1998-2 C.B. 34 (withdrawing Notice 98-11).

3 More recently, the Obama administration dropped its proposal to repeal the check-the-box rules for foreign entities because the main effect of such repeal would be to unwind U.S. multinationals' foreign tax minimization planning.

Ultimately, in considering the appropriate reaction to profit shifting and base erosion whose primary impact is *foreign* tax minimization, we must consider carefully whether the United States has an interest in imposing and enforcing rules whose primary beneficiaries are foreign fiscs, rather than the U.S. treasury.

It is true that under current law the potential for low-taxed income on foreign sales can encourage U.S. companies to manufacture their products abroad rather than in the U.S. But if that is a concern, the remedy should be to change the rules that force companies to manufacture abroad in order to obtain low-taxed earnings. Base erosion Option C in the international tax reform discussion draft released by this committee offers one approach to achieving this result. Elsewhere I and others have suggested alternative approaches.[4]

IV. Allocating Income Based on Business Activities vs. Business Risks

In considering whether profit has been improperly shifted or the tax base eroded, it is also critical to keep in mind that it is not only the location of activities but also the location of costs that must be taken into account. If we are to employ arm's-length pricing principles in the context of intercompany transactions, we must recognize the fact that in arm's-length transactions it is the party that bears the costs – and takes the financial risks – of a business that earns the bulk of the return from that business. In contrast, a service provider that conducts activities but does not bear financial costs or risks generally gets only a modest return. Focusing exclusively on where activities – such as product development – are conducted and ignoring the location of the funding for those activities does not give an accurate account of where profits are properly earned, and thus leads to a distorted account of whether profits have been shifted.

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[4] *See* Sullivan, Economic Analysis: U.S. Contract Manufacturing and Dave Camp's Option C, 139 Tax Notes 10 (Apr. 1, 2013).

This is no less true where the allocation of costs is done between and among members of a multinational corporate group. Take Apple as an example. Much has been made of the fact that its relocation of funding obligations from the United States to its Irish affiliate pursuant to its cost sharing agreement was all "in-house" and had no actual economic impact on Apple. From a global consolidated group perspective that is surely true. Whether Apple U.S. or Apple Ireland bears a cost does not affect the Apple group's pre-tax profit calculated on a global consolidated basis. But it can and does affect its after-tax profit in individual countries. Expense deductions in the United States that reduce U.S. taxable income are far more valuable than deductions taken in low-tax jurisdictions. And it certainly affects the United States government, which via the income tax system is effectively an equity investor in Apple U.S. Because the United States taxes net business income, the treasury effectively bears 35% of the cost of Apple's U.S. business expenses, and is entitled to a return by collecting 35% of Apple's profits. If a cost is shifted outside the United States such that it is no longer deductible in the United States, then the United States government no longer bears the cost of that deduction and correspondingly loses its entitlement to an appropriate amount of the resulting income. Ignoring the location of business expenses in determining where income should be taxed results in a misallocation of income, and a potential misdiagnosis of the problem of profit shifting.

The problem of ignoring the location of funding costs is not limited to countries asserting taxing jurisdiction based on the location of product development activities. Market countries asserting such jurisdiction also often fail to recognize that taxing intangible property income requires some recognition of the costs of product development.

V. Is Cost Sharing Part of the Problem or Part of the Solution?

The three concerns discussed in the three preceding sections – the need to properly distinguish between U.S. and foreign sales, the need to consider our attitude toward foreign tax minimization planning, and the need to give proper credence to the allocation of business expenses and risks – suggest that much of the criticism that has been heaped on cost sharing following the PSI hearing on Apple is overstated and may in fact be counterproductive. Fundamentally, cost sharing arrangements achieve two important goals that align with the above discussion: First, they provide a framework for allocating income based on where sales are made. They thus recognize the principle that, at least with respect to consumer items, much of the value associated with goods like consumer products inheres in the marketplace, which is properly allocated to the market jurisdiction, and not the place of development.[5] Likewise, cost sharing arrangements have the effect of allocating costs to the same jurisdiction that earns the resulting income. They thus match income and expenses – or investment and return – which is appropriate both from the perspective of the entity that bears that cost and from the perspective of the government that is an effective co-venturer in that endeavor.

This is not to say that cost sharing arrangements are free from their fair share of issues. There are questions surrounding how to determine cost sharing buy-in payments (although that has largely been addressed through regulations that were published in proposed form in 2009 and finalized in 2011 which, if anything, take too broad a view of what kind of

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5 In this regard, recent indications that the Treasury and IRS may promulgate regulations including in the definition of intangible property for section 367(d) purposes the value associated with foreign goodwill and foreign workforce in place is troubling. Items of property that properly belong to the market country should not be viewed as "belonging" to the United States and therefore subject to taxation upon their supposed outbound transfer. Indeed, strong arguments can be made that section 367(d) is overly broad today as applied to foreign customer-based intangibles developed by foreign branches of U.S. companies.

payment is necessary to "buy into" cost-sharing).[6] In business-to-business transactions the location of sales is a vexing issue. Likewise, there is reasonable disagreement about the types of costs that should be subject to sharing under a cost sharing agreement, and whether the cost reimbursement mechanism under the cost sharing rules adequately compensates the service-providing parties for their development activities.[7]

But these concerns – about which reasonable people can disagree and which could help improve cost sharing agreements at the margins – should not cast doubt on the fundamental wisdom of cost sharing arrangements. I believe these arrangements could provide a model for the taxation of cross-border income because they minimize incentives to move factors of production to reduce global taxes and minimize the friction of determining the proper allocation of intangible profit among taxing jurisdictions.

Today we have what many economists would described as an "origin-based" income tax system; income is taxed where the relevant input cost and activity factors are located. Since for most multinational companies taxes are the biggest single expense on their financial statement, an origin-based income tax provides large incentives to migrate costs and activities as is necessary to reduce global taxes. We have seen this in the United States; over the past 30 years manufacturing activities in many sectors have migrated abroad, in part as a result of our tax rules that make such foreign manufacturing essential to minimizing the taxation of intangible profits on sales outside the United States.

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6 *See* Treas. Reg. § 1.482-7. It is worth noting that according to the documents released in connection with the PSI hearing, Apple first entered into its cost sharing agreement in 1980, so we are well past any concerns about its buy-in payment.

7 Arguably the service provider should receive a mark-up on the costs it incurs rather than simple reimbursement for those costs. But in general one would not expect that to be a substantial item. Apple, for example, spends less than 3 percent of its revenues on R&D. Obtaining a 10 percent "profit" on those costs would not substantially impact its U.S. taxable income.

The one factor that economists agree is the most difficult to migrate is sales. The location of customers in consumer businesses is fixed. U.K. customers are not going to move to Ireland to buy Apple products. This leads many economists to advocate what is called a "destination-based" income tax.

Since most cost-sharing agreements allocate income based on third-party sales, they provide a framework for a destination-based allocation of intangible profits for income tax purposes. As a result, cost-sharing companies have no incentive to migrate their product development activities outside the United States. If instead we proceed with an "origin-based" allocation of profits to product development activities, I worry that 30 years from now we could observe a migration of such activities that parallels the migration of manufacturing activities over the past 30 years.

A second fundamental advantage of cost-sharing is that it can be administered. Arm's-length transfer pricing has been understandably criticized for being, at best, subjective and thus subject to manipulation by taxpayers or, at worst, impossible to administer because of the lack of real world transactions remotely comparable to intercompany intangible property transfers. The sharpest critics of arm's-length pricing typically suggest that some form of formulary apportionment of income would be preferable.

Yet, the various formulary apportionment proposals that have been put forth in recent years, including the Common Consolidated Corporate Tax Base proposal put forth by the European Union, are in many respects just cost sharing taken to its logical conclusion. Formulary apportionment – at least to the extent that apportionment is based on sales – effectively treats all the costs and income of a corporate group as allocable on a proportionate basis to the jurisdictions in which the group makes its sales. It thus achieves a perfect matching of income and expenses while allocating all or nearly all intangible profit to market countries.[8]

In my view, rather than being a source of profit shifting and base erosion, cost sharing – with some improvements – may in fact be part of the solution. Indeed, I would argue that major progress on "profit shifting" could be accomplished if all the major developed countries were to mandate cost sharing for inbound as well as outbound product sales, and apply cost sharing not just to product development expenses but to global marketing and G&A expenses as well. It would raise revenue. It would eliminate incentives to migrate product development activities. And in the United States, if it is done together with some modest, but critical, improvements to the subpart F rules – the foreign base company rules in particular – it would also help remove the tax barriers facing those who wish to manufacture in the United States for export to foreign markets.

VI. Implications for Base Erosion in the Context of International Tax Reform

The themes discussed so far have important implications for any anti-base erosion subpart F proposals that might be adopted in the context of broader international tax reform. No one doubts that in the context of implementing a territorial tax system along the lines detailed in the Discussion Draft released by this committee in October of 2011, new anti-base erosion measures will need to be adopted to ensure that the U.S. tax base is properly protected. The themes and concerns discussed above suggest that base erosion Option C from the Discussion Draft offers a well-designed starting point for crafting an appropriate base erosion proposal

[8] The extent to which income is allocated to market countries depends on which factors are used for the apportionment and what weight is given to each of those factors. Traditionally, the three factors of sales, assets, and employees have been used, though jurisdictions employing formulary apportionment – such as the states in the United States – have tended over time to rely more heavily on location of sales, in part because that is the factor least subject to control and manipulation by the taxpayer.

because it is fundamentally based on the distinction between U.S. sales and foreign sales that is critical to preserving the essential character of a territorial system.

Where transfer pricing rules are insufficient to prevent the profit of U.S. multinationals from sales to U.S. customers from being shifted outside the U.S., an expansion of subpart F to include such profits may well be appropriate. Of course, under current law a principal reason why such profits are outside the U.S. is investment in R&D and plant and equipment by foreign affiliates of U.S. multinationals. Any expansion of subpart F to tax those profits should include transition rules to avoid taxing income attributable to pre-existing investments. Going forward, an expansion of subpart F would prevent erosion of the U.S. tax base and level the playing field with respect to manufacturing activities for the U.S. market.

Whether subpart F should apply to foreign sales of products manufactured outside the United States (as Option C would albeit at a lower rate) is more questionable, and depends in part on whether one thinks that the U.S. tax system should discourage foreign tax minimization. This is an area for caution. At a low rate such a tax would raise little revenue for the United States because it would typically be less expensive for multinationals to unwind their foreign tax planning. But at higher rates the increase in combined U.S. and foreign taxes could have a potential long-run competitive impact on U.S. multinationals. Over time that will inevitably lead to more multinationals incorporating abroad and, to the extent necessary, moving activities abroad.

A few years back I suggested that the major developed countries might work together to adopt CFC rules that constrained this kind of tax planning in a way that would minimize the competitive impact on any one country's multinationals.[9] I understand the U.S. Treasury may be taking that view in the OECD BEPS discussions. If other major countries were to agree, then the Discussion Draft's Option C (as it applies to foreign sales – or even a variant of the Obama Administration's minimum tax applied to such sales) could make sense. But I am very skeptical other countries are interested in taxing their multinationals in that manner. By and large they see their multinationals as their "champions," to be encouraged to grow and expand around the world, and thus have little interest in raising revenue from their activities outside their home country. Instead, their focus is taxing the market-related activities of other countries' multinationals.

While I am somewhat skeptical of the base erosion Option C provision taxing (albeit at a reduced rate) intangible profits attributable to foreign sales, I do agree with its companion provision that taxes intangible profits attributable to exports only to the same extent that intangible profits from foreign sales are taxed. That provision goes a long way to leveling the playing field between foreign and domestic manufacturing of products for sales abroad. When combined with the application of subpart F to foreign manufacturing for sales back to the United States, base erosion Option C minimizes the current law incentives to manufacture abroad.

VII. Conclusion

Corporate profit shifting and tax base erosion is an important issue that must be faced by both governments and corporations. But any honest and productive discussion of the topic must begin by first considering where profit *should* be located; only then can we begin to

[9] *See* Oosterhuis, The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy: The Evolution of International Tax Policy - What Would Larry Say?, 33 OHIO N.U. L. REV. 1 (2007).

determine whether it has been improperly shifted. I would suggest that a corporation's place of residence or the location of its activities or how much foreign tax it pays are not likely to provide useful – and certainly not complete – measures of profit shifting. A focus that is geared towards the location of sales and the matching of income and expenses is far more likely to produce useful measures of – and thus productive solutions to – the issue of U.S. profit shifting and base erosion.