Taxing Success: Income Shifting and the U.S. Taxation of Nonroutine Returns Earned by Foreign Subsidiaries

By Rocco V. Femia

Rocco V. Femia summarizes the tax and economic environment applicable to U.S.-based multinational corporations, explores the income-shifting phenomenon itself and outlines policy proposals that have been motivated by the income-shifting phenomenon.

Policymakers, academics and other commentators are taking aim with increasing frequency on the "shifting" of income by U.S.-based multinational enterprises ("U.S. MNEs") from the United States to low-tax jurisdictions through transfer pricing practices. The tax and economic environment faced by U.S. MNEs provides strong incentives for such behavior. A steady stream of provocative articles in the popular and financial press report on companies using such transfer pricing practices to reduce their tax burdens.[1] The amounts involved can be staggering; effective transfer pricing practices can reduce significantly the overall tax burdens of MNEs, and transfer pricing disputes with tax authorities can sometimes involve the allocation of billions of dollars of income over several years.[2]

For decades, transfer pricing rules premised on the arm's-length standard have been the principal tools available to tax authorities to address income shifting. Regulators have undertaken significant efforts over the last 20 years to develop and refine such rules.[3] Recently, however, policymakers and commentators have proposed alternative ways of addressing income shifting by either limiting the incentives favoring income shifting or by scrapping the arm's-length standard altogether. The Obama Administration, for example, has proposed expanding the Subpart F regime to tax U.S. companies on "excessive" returns earned by low-taxed foreign subsidiaries.[4] These proposals are justified in part by reference to empirical data demonstrating that the income of U.S. MNEs earned in low tax affiliates is disproportionate to the other economic factors, such as sales, payroll, or property, plant and equipment (PPE) in such affiliates.

Part I of this article summarizes the tax and economic environment applicable to U.S.-based multinational corporations ("U.S. MNEs"), which has an impact on the ability of and incentives on U.S. MNEs to shift income through transfer pricing practices, to provide background for the discussion of the income-shifting phenomenon and potential policy responses. Part II explores the income-shifting phenomenon itself: the observed allocation of taxable income to low-tax foreign affiliates of U.S. MNEs that is disproportionate to other economic factors, such as sales. This part outlines the empirical work designed to show the extent to which income shifting is due to aggressive or abuse transfer pricing practices, rather than to other factors such as tax sensitive but compliant transfer pricing practices, and describes the manner in which U.S. MNEs may shift income consistent

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with the current transfer pricing rules. This part concludes that it is not possible to determine the extent to which income shifting is due to compliant or noncompliant behavior, but that this conclusion may not be relevant to the extent policymakers view the negative effects of income shifting as arising from income shifting itself regardless of cause. Part III outlines a handful of recent policy proposals that have been motivated by the income-shifting phenomenon, and assesses each proposal in terms of the extent to which it would address income shifting with or without regard to whether it is caused by transfer pricing practices inconsistent with the arm's-length standard. This part also discusses several more comprehensive proposals that might be elements of future tax reform and assesses the impact of each on income shifting, including whether the proposal would materially alter the incentive of U.S. MNEs to shift income. Part IV offers concluding thoughts.

Current Tax and Economic Environment Applicable to U.S. Multinationals

The tax and economic environment applicable to U.S. MNEs has an impact on the ability of and incentives on U.S. MNEs to shift income through transfer pricing practices. This part summarizes the U.S. international tax rules, including the U.S. transfer pricing rules, applicable to U.S. MNEs, and places them in the context of global international tax and transfer pricing norms as well as economic trends affecting U.S. MNEs. This discussion provides background for the discussion of the income-shifting phenomenon and potential policy responses.

Current Substantive U.S. International Tax Rules

The United States in general taxes U.S. persons, including corporate entities incorporated under U.S. law, on their worldwide income.[5] In contrast, the United States taxes foreign persons only on income related to U.S. business operations, and applies a withholding tax on certain outbound payments to foreign persons.[6]

Under longstanding U.S. tax principles, a corporation is treated as a taxable person separate from its shareholders, and income earned by a corporation is not taxable to the shareholder until it is distributed.[7] Under this principle, if a U.S. corporation conducts its foreign business operations through a foreign subsidiary, the income earned by that foreign subsidiary is not be taxed by the United States until it is distributed to the U.S. corporation. Similarly, losses incurred by the foreign subsidiary are not recoverable by the U.S. corporation. The deferral benefit creates a significant incentive for U.S. MNEs to shift income to low tax affiliates and defer repatriations.

Various anti-deferral regimes, notably the so-called Subpart F rules applicable to greater-than-10-percent U.S. shareholders of controlled foreign corporations (CFCs),[8] apply to accelerate (or eliminate the deferral of) U.S. taxation of such U.S. shareholders on income earned by foreign subsidiary corporations. These rules are complex. In general, the rules impose current U.S. tax on U.S. shareholders of CFCs on enumerated categories of income, notably passive income (such as dividends, interest, and royalties) and certain other categories of "foreign base company" income.[9] These items are treated as deemed distributions to the U.S. shareholders. Most active business income, including manufacturing income, income from local-country sales, income from local-country services, active rents or royalties earned from a third party, and income from local-country active financing activities, is excepted.[10] Further, since 2005 the statute generally permits active business income to be shifted from one CFC to another through payments of dividends, interest, or royalties without triggering an inclusion at the U.S. shareholder level.[11] This facilitates the intragroup foreign-to-foreign movement of funds without U.S. tax consequences, as well as incident tax planning where funds are moved from a high-tax jurisdiction to a low tax jurisdiction through a deductible payment. Before 2005, taxpayers could achieve somewhat similar results through planning under the "check-the-box" entity classification rules effective in 1997.[12] The Subpart F rules also impose U.S. tax on a U.S. shareholder's share of its CFC investment of earnings in certain U.S. property, on the theory that such an investment constituted an effective repatriation of earnings.[13] Losses incurred by CFCs are not recoverable by U.S. taxpayers, at least on a current basis, even if they are attributable to activities or assets that would otherwise give rise to Subpart F income.

To mitigate double taxation on foreign income earned by U.S. persons, a foreign tax credit is provided. A U.S. corporation may credit the foreign income taxes that it pays directly as well as the foreign taxes paid by its foreign subsidiaries when

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the earnings of such subsidiaries are distributed to or otherwise included in the income of the U.S. corporation.[14] In general, the foreign tax credit is limited to a taxpayer's U.S. tax liability on its net foreign source income.[15] Net foreign source income is determined under U.S. principles. Income is categorized as foreign source under U.S. sourcing rules, and expenses are allocated to the foreign source income.[16] U.S. law provides for formulaic allocation of certain significant categories of expense, in particular interest (allocated on the basis of assets) and R & D (a portion of which is allocated to the location of R & D, with the remainder allocated in accordance with gross income or sales).[17] Separate limitations, or baskets, are provided for passive income and other ("general limitation") income.[18] A taxpayer whose foreign tax credit is limited by the amount of its net foreign source income is said to be "excess credit"; a taxpayer that could credit additional foreign taxes is said to be "excess limitation."

Transfer Pricing Rules

The United States has an extensive body of transfer pricing rules designed to ensure that each taxpayer reflects its true taxable income notwithstanding transactions and other arrangements with related persons.[19] The general standard applied under these rules is the "arm's-length" standard.[20] Thus, if the transfer prices of transactions in goods, services, and other items between related persons are consistent with the prices that would be charged by unrelated persons in similar transactions under similar circumstances, then the transfer prices are appropriate. In the case of a transfer of intangibles, the statute provides that the income from such a transaction must be commensurate with the income from the transferred intangible.[21] The commensurate-with-income standard has been implemented through rules permitting "periodic adjustments" to amounts charged in the context of transfers of intangible property; that is, the IRS may make adjustments to consideration for transferred intangible property based on the actual profitability of the property in the hands of the purchaser.[22] Further, the regulations provide a complicated regime for cost-sharing arrangements for the development of intangible property, including recent regulatory changes addressing the pricing of contributions of pre-existing intangible property for further development in a cost sharing arrangement.[23]

A natural consequence of the arm's-length standard is that taxpayers need not charge related persons in circumstances in which an independent party could not legally or economically charge an unrelated person. For example, courts have held that no compensation is due if compensation would have been legally barred under local law,[24] or if the putative transfer at issue could have been obtained by the transferor without compensation.[25] This later point is particularly relevant in the case of bare business opportunities that are not associated with contract rights. Such opportunities generally may be "allocated" among group members without compensation.[26]

The concept of comparability is central to an application of the arm's-length standard. In general, the results achieved by a taxpayer from a transaction, arrangement, or line of business involving related parties is measured against the results achieved by comparable persons in similar circumstances. The first step in this analysis often is a functional analysis of the taxpayer (or the related counterparty) to determine the functions conducted, assets held, and risks borne by the taxpayer.[27] In this regard, the U.S. regulations generally respect intercompany contracts and other arrangements, including the allocations of risk in such contracts.[28] Further, the IRS generally is not permitted to recast the terms of a related party transaction unless the contractual terms have no economic substance or the actual behavior of the taxpayers is inconsistent with the contractual terms.[29]

The U.S. regulations specify several methods for determining whether the results of related party transactions are consistent with arm's-length results, and provide for facts-and-circumstances analysis to determine the appropriate method to apply. There is no hierarchy of methods; rather, the "best" method under the facts and circumstances should be applied.[30] Multiple methods may be used, and a convergence of results from two or more methods provides strong evidence of an appropriate price.[31] Some methods, such as profit split methods, are "two-sided" methods—that is, they require a functional analysis of each party to the related party transaction or arrangement to determine the appropriate price. Most methods, and the most widely used methods in practice, are "one-sided" methods—that is, they require a functional analysis of only one party to the transaction, sometimes referred to as the "tested party," to determine the appropriate price. The cost-plus method, resale-minus (or gross margin) method, and comparable

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profits method each is a one-sided method. When a one-sided method is used, the residual profit or loss from a transaction or arrangement incidentally will inure to the related person other than the tested party, often without additional scrutiny.

The transfer pricing rules do not exist in a vacuum. Rather, they interact with the substantive rules of the tax law, including the statutory nonrecognition provisions and judicial anti-abuse doctrines. In general, the substantive tax rules, including judicial anti-abuse doctrines, apply first to determine the character of a transaction or arrangement, including whether the form of the transaction should be respected and whether transaction is taxable. Once the transaction or arrangement has been characterized for substantive tax purposes, the price of the transaction (or the profits from an arrangement) is determined under the transfer pricing rules. There is limited case law that sometimes is cited for the proposition that the transfer pricing rules can override the nonrecognition rules of the Code to convert a nonrecognition transaction into a taxable transaction.[32] These cases, properly understood, may stand instead for the more limited proposition that judicial anti-abuse doctrines may apply to recast what appears to be a nonrecognition transaction into a taxable transaction, which then is priced under the transfer pricing rules.

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One area of intersection between the nonrecognition provisions and the transfer pricing rules is the outbound transfer rules of Code Sec. 367(a) and (d) and the regulations thereunder. In general, the transfer of assets by a U.S. corporation to a CFC in a transaction that would qualify as a nonrecognition transaction if the CFC had been a U.S. corporation with qualify for nonrecognition treatment if such assets will be used by the CFC in an active trade or business outside the United States.[33] There are numerous exceptions to this general rule, such as for assets that are expected to turn over quickly (such as inventory) and, notably, for intangible property, defined by reference to an enumerated statutory list.[34] There is a further regulatory exception to this exception for foreign goodwill and going concern value; that is, a U.S. corporation can transfer foreign goodwill and going concern value to a CFC (presumably in the context of the transfer of other business assets) tax free.[35] Intangible property that is taxable under Code Sec. 367(d) is subject to rules akin to the transfer pricing rules. The rules under Code Sec. 367(d) require that the income from the transfer of intangibles be commensurate with the income from the intangibles transferred, which echoes the standard in the second sentence to Code Sec. 482.

U.S. Rules in the Broader Context

Consensus Transfer Pricing Standard

The U.S. international tax rules as applied to U.S.-based multinationals interact in important ways with the tax rules of other countries. Perhaps most notably, almost all significant U.S. trading partners have transfer pricing rules, and almost all significant U.S. trading partners subscribe to the arm's-length standard. This standard is memorialized in Organization for Economic Cooperation and Development (OECD) Guidelines, to which all members of the OECD subscribe, as well in virtually all U.S. bilateral income tax treaties.[36] An international standard in the transfer pricing area is important so as to avoid competing tax claims to the same income (double taxation) by providing countries with a common principle for resolving disputes. While the OECD Guidelines differ in some respect from the U.S. regulations and the domestic law of other countries, in principle all OECD countries, and many significant non-OECD countries, apply similar standard and approaches to determining appropriate transfer pricing.

The concerns regarding "income shifting" addressed in this article are not limited to the United States. Other countries have similar concerns, and have attempted to address such concerns in their domestic law and multilaterally at the OECD. For example, the OECD recently undertook a significant project on the tax treatment of business restructurings, addressing such issues as whether the allocation of "profit potential" among group members is a compensable event (the OECD concluded it was not).[37] Even more

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recently, the OECD has commenced a project on transfer pricing issues related to the transfer of intangible property.[38]

High Rates and Global Reach

The U.S. international tax system also operates in parallel with, and in some sense in opposition to, the systems of significant trading partners. At the margin, U.S.- and foreign-based multinationals take tax factors into account when locating investments. The U.S. system is different from the systems of most of its trading partners in two material respects.

First, most U.S. trading partners have "territorial" systems that largely exempt from tax the foreign active business earnings of the foreign subsidiaries of their resident multinational taxpayers. As recently as 10 years ago, the split between worldwide systems and territorial systems among significant economies was relatively even. The tide since then has turned decidedly in favor of territorial systems, with the United Kingdom and Japan each converting in 2009. Although countries with territorial systems typically tax royalties, some countries have introduced or are considering "patent box" regimes, whereby certain income from certain intangible property would be taxed at lower rates.[39]

Second, U.S. statutory corporate tax rates are relatively high, and well above the statutory corporate tax rates of significant trading partners such as Canada, the United Kingdom, and Germany.[40] These countries are not "tax havens" or even traditional low-tax jurisdictions; rather, they are countries with robust legal and regulatory environments and expansive social safety nets whose economies compete for similar types of investment and jobs as that of the United States. Further, while the U.S. corporate tax rate has remained about the same since 1988, the corporate tax rates of its significant trading partners has trended down.[41]

Limited Scope of U.S. Rules Applicable to U.S. MNEs

The U.S. tax environment faced by U.S. MNEs is different than that based by competing businesses with operations within and outside the United States.

Foreign-based multinationals with operations in the United States are subject to U.S. tax on the income of their U.S. subsidiaries as well as on income related to any U.S. permanent establishment or trade or business.[42] They are also subject to withholding taxes on certain categories of income, such as interest, royalties and dividends, that are paid from affiliates and unrelated persons the United States;[43] these withholding taxes are reduced and sometimes eliminated on a reciprocal basis under U.S. tax treaties. The Subpart F regime does not apply to foreign-based multinationals.

A significant percentage of business income in the United States is earned by noncorporate groups, including noncorporate multinationals. These could include businesses organized as partnerships, limited liability companies or S corporations. To the extent these U.S.-based noncorporate groups have foreign operations, they face a significantly different landscape than U.S.-based MNEs due to the operation of the indirect foreign tax credit. In general, individuals are not entitled to credit the taxes paid by foreign subsidiaries held directly or indirectly through partnerships, LLCs, or S corporations.[44] Thus, in general, noncorporate groups have a choice of either maintaining deferral and forgoing the opportunity to credit foreign taxes, or instead forgoing deferral and ensuring the ability to credit foreign taxes.

Declining Primacy of U.S. MNEs

Although U.S.-based MNEs remain a vital part of the U.S. and world economies, their role is shrinking. In the last 10 years, the number of U.S. MNEs included among the 500 largest companies in the world has declined 22 percent, from 179 to 140.[45] This decline tracks the decline in the U.S. share of world GDP over that same time period,[46] although U.S. MNEs continue to make up a disproportionally high percentage of total large MNEs relative to the size of the U.S. economy. Further, certain foreign economies, particularly so-called emerging markets such as China, India, and Brazil, have been growing and are expected to continue to grow at a faster rate than the U.S. economy.[47] As foreign markets continue to grow, one would expect a continuing decline in the percentage of U.S. MNEs among total large MNEs. Further, one would expect the relative percentage of foreign sales and activities of large U.S. MNEs to increase.

What Is Income Shifting, and Is It a Problem?

Policymakers and commentators (including this one) use the term "income shifting" to describe the results of a spectrum of outcomes or behavior, often without explicitly defining what is intended to be conveyed by the term. At base, the income-

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shifting phenomenon refers to arrangements that allow the location of taxable income in entities in an amount that is disproportionate to the economic activity of such entities as measured by objective and tangible factors, such as payroll, sales or PPE. Further, many policymakers and commentators use the term "income shifting" to refer to such arrangements to the extent the outcomes are due to aggressive or abusive transfer pricing practices, or transfer-pricing practices inconsistent with the arm's-length standard, rather than due to other factors.[48]

This part explores the extent to which income shifting from aggressive or abusive transfer pricing practices can be shown to exist from the empirical work done in this area, and posits a potential counter explanation—that significant amounts of income shifting may be due to compliant, albeit tax motivated, transfer pricing practices. This part also explores the extent to which income shifting from whatever source is problematic from a tax policy perspective by assessing the policy objections most often expressed in this context.

Empirical Data Related to Income Shifting

There has been significant empirical work designed to determine the extent to which U.S. MNEs shift income from the U.S. tax base to low-tax jurisdictions through transfer pricing practices.[49] Recent work shows that the income of foreign affiliates of U.S. MNEs has been growing faster than the growth in other economic factors, such as sales, payrolls or PPE, and that this trend is even more pronounced for low-tax foreign affiliates. The work further shows that CFCs in lower tax environments earn higher returns even after controlling for factors such as sales and assets, and that at least some of these returns appear to be driven by the difference between effective U.S. and local tax rates. The data on which these studies are based, however, have significant limitations.

Summary of Empirical Work

Some empirical work on this question has been based on aggregate data, for example the financial data complied by the U.S. Bureau of Economic Analysis (BEA) or the tax data reported by the IRS Statistics on Income Division. In general, the BEA data compile the revenues, payroll, PPE, profits and other financial attributes of all foreign affiliates of U.S. MNEs on a country-by-country basis. These data show significant growth among all economic factors related to foreign affiliates of U.S. MNEs over recent periods, as would be expected given the relative growth of foreign markets as compared to the U.S. market. Pre-tax profits, however, have grown substantially faster than economic factors such as sales, PPE and payroll. For example, while the sales, PPE and payroll of foreign affiliates of U.S. MNEs from 1999 to 2007 increased 108 percent, 50 percent and 66 percent, respectively, the profits of those affiliates increased 163 percent.[50] Further, the ratio of profits to sales, PPE or payroll is significantly higher for foreign affiliates in some low tax countries than average. For example, the operating margins (the ratio of operating profits to sales) of foreign affiliates in Bermuda, Ireland, and the Cayman Islands are 20 percent or higher, compared to nine percent worldwide; further, the ratio of profits to payroll is extraordinarily high for foreign affiliates in Bermuda (over 70 times the worldwide average) and the Cayman Islands (almost 25 times the worldwide average).[51]

Other empirical work is based on company specific data, including financial reporting data and tax return data. The recent work with tax return data has been performed principally by economists at the U.S. Treasury Department, who have access to taxpayer-specific data in accordance with limits on disclosure of such data. Recent work with tax return data has suggested two conclusions. First, CFCs organized in lower tax environments have higher operating margins (the ratio of operating profits to sales) than CFCs in higher tax environments.[52] For example, in 2002, the weighted average operating margin of CFCs organized in zero-tax jurisdictions was over 20 percent, which the weighted average operating margin of CFCs organized in tax jurisdictions whose statutory rates were over 35 percent was less than 10 percent.[53] The negative correlation between operating margins and statutory tax rates holds even when controlling for factors such as asset intensity, MNE size and years of operation, and the negative correlation appears to be getting stronger over time.[54] Second, at least some of this effect can be explained by the differential between U.S. and local effective tax rates.[55] Recent empirical work has estimated that approximately half of the 14 percentage point increase in relative profits of U.S. MNEs reported by CFCs between 1996 and 2004 can be explained to the differentials between U.S. and foreign tax rates.[56]

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Limitations of Empirical Data

In evaluating the strength of conclusions drawn from the empirical work, it is important to consider the significant limitations the data underlying the work.

Data based on financial reporting, such as the aggregate BEA data, focus on financial profits earned by foreign legal entities (without regard to whether such entities pay U.S. tax currently or not), rather than taxable income earned by deferral vehicles such as CFCs. Care must be taken in removing profits from intragroup equity and debt holdings, which likely would tend to skew in favor of entities in lower tax environments but which are not suggestive of income shifting through transfer pricing. Even if such profits are removed financial profits and accrued taxes determined pursuant to financial accounting standards are an imperfect proxy for taxable income and taxes paid, there is some risk in using data regarding the first set to draw conclusions regarding the second.

Importantly, neither financial data nor tax return data can account for allocations of risk or the economic ownership of intangible property, perhaps the two most significant factors in determining the location of residual returns under basic transfer-pricing analyses consistent with the arm's-length standard. This shortcoming limits the conclusions that can be drawn from the empirical work, as the more carefully worded studies themselves readily admit.[57] Further, although a strength of the tax return data (or other individual company data) is that it can be filtered and otherwise refined, some of the choices made in filtering may themselves add bias relating to allocated risks. For example, the recent studies by U.S. Treasury economists focus only on the CFCs of the largest U.S. MNEs, and filter out CFCs that earn losses. The rationale for excluding loss companies may be that loss companies are not sensitive to the tax rate environment of their operations. To the extent high returns in low-tax CFCs are driven by the bearing of risk, however, excluding loss companies could overstate the income-shifting phenomena. If the CFCs in low tax environments experienced either extraordinary returns or extraordinary losses depending on the outcome of the risks undertaken, excluding the loss CFCs would give a distorted view.[58] Similarly, focusing on the CFCs of the largest MNEs may result in a kind of success or survivorship bias, as the largest MNEs are likely to be the companies experiencing the best outcomes in terms of their business risks over recent periods.

Finally, one significant limitation of tax return data is that it is available only to a small group of researchers, namely government economists. It is not clear whether it is possible to convey some of this underlying data in a usable form without violating restrictions on the disclosure of taxpayer information. In light of the fact that significant policy proposals in this area are being justified based in part on conclusions drawn from this data, it would be ideal if the data could be more widely disseminated consistent with privacy protections, which would allow academics and private sector economists a greater ability to test and refine such conclusions.

Strength of Conclusions Drawn from Empirical Work

Empirical work of the type highlighted above, in particular the work based on tax return data, is viewed by policymakers at the Treasury as providing "evidence of substantial income shifting through transfer pricing."[59] The Treasury has further concluded that this income shifting is due to inappropriate or abusive transfer-pricing practices that are not in accordance with the arm's-length standard, and in that context has continued to endorse the arm's-length standard.[60] Is that a fair conclusion for policymakers to draw?

Commentators and academics have come to different views on the strength of the conclusions that can be drawn from the empirical data, with some arguing that the empirical work demonstrates inappropriate income shifting on a massive scale,[61] and others expressing more caution.[62] Given the results of the empirical work to date, and the limitations of the data underlying this work, what conclusions can or should policymakers reasonably draw from such work? There is little doubt that the profits of CFCs organized in low-tax countries are disproportionately high relative to other economic factors such as sales, payroll and PPE. All of the empirical work points in the same direction: Profits bear an inverse relationship to statutory or effective tax rates.[63] However, due to the limitations of the data, it is difficult to isolate with certainty the cause of this phenomenon. Another conclusion is possible—that the empirical data reflect income shifting due to transfer pricing practices that are tax-motivated but nevertheless consistent with the arm's-length standard as commonly understood.

Income Shifting Consistent with the Arm's-Length Standard

A bare shift of "income," for example, through a transfer of a right to receive income already earned, would not be given effect under U.S. income tax

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principles.[64] Future income, however, may be shifted, or allocated, within a controlled group in a number of ways.[65]

Income Shifting Through the Allocation of Business Opportunities or the Transfer of Assets

A taxpayer may select the entity in its group that takes advantage of a business opportunity available to the group.[66] In this sense, the future income (or losses) from that opportunity, net of payments to affiliates and otherwise for services or other activities that contribute to the venture, will be located with the entity that is selected to pursue it. It is also possible to re-allocate business opportunities within a group in the context of an ongoing venture without given rise to a compensable transaction.[67]

Further, future income can in effect be shifted through a transfer of assets, including the transfer of contractual rights to earn income in the future. To illustrate this point, consider the sale of a portfolio of somewhat distressed notes. Following the transfer, the purchaser is entitled to income from the notes; in this sense, income has been shifted from the seller to the purchaser. The seller, of course, is entitled to compensation on the transfer, and such compensation will reflect expected future income flows from the notes. Following the transaction, however, the seller will be in a fundamentally different economic position; it will have monetized its position on the note and shifted any risk associated with expectations of repayment on the note to the seller. Because there are expected returns to risk, one would expect the purchaser of the notes to derive net income from the transaction to compensate it for the risk it bears. If the notes perform as or better than expected, then additional income will have been shifted from the seller to the buyer.

If an outbound transfer of assets meets the conditions in Code Sec. 367(a)(3), there is no U.S. tax on the transfer. In this case, not only is the future income from the asset shifted to the purchaser, but the built-in gain on the asset is shifted as well.

Outside of noncompensable transactions such as allocations of business opportunities and nonrecognition transactions covered by Code Sec. 367(a)(3), the extent to which the income shifted on the transfer of assets or rights is appropriate under arm's-length principles depends on the extent to which the transfer is identified and treated as compensable, as well as the pricing of that transfer. On one end of the spectrum is clearly noncompliant behavior, for example the fraudulent booking of income in a low-tax affiliate notwithstanding the fact that the rights and assets necessary to the generation of that income are held elsewhere. While this no doubt occurs, policymakers cannot reasonably believe that this sort of behavior is endemic among large (particularly listed) U.S. MNEs. On the other end of the spectrum are compliant transfer pricing practices that nevertheless result in transfers of risk and therefore the shifting of income consistent with arm's-length principles. Between these two extremes is a gray area, where taxpayers take defensible positions that may be subject to legitimate questioning by tax authorities and give rise to good-faith disputes.[68]

Income Shifting as Illustrated by the JCT Report

It may be worthwhile to illustrate in a more concrete manner how taxpayers can employ transfer pricing practices to shift income in a manner that is compliant with, or arguably compliant with, the current rules. Such proactive transfer pricing and other international tax planning was featured in a recent report prepared by the Joint Committee on Taxation (JCT) in conjunction with a hearing on income shifting before the Committee on Ways and Means.[69]

The JCT used taxpayer information to develop six case studies (coded Alpha, Bravo, Charlie, Delta, Echo and Foxtrot), which were not randomly selected but rather selected to demonstrate the use by U.S. MNEs of transfer-pricing planning. The structures in those studies had common elements, which are outlined below.[70] Intangible property was obtained by a CFC through a license or by entering into a cost sharing arrangement. That CFC would on-license the intangible property to a CFC acting as a regional principal (or the CFC holding the intangible property itself would act as the regional principal), and the regional principal in turn would engage foreign and sometimes U.S. affiliates to provide manufacturing, distribution and other services. The affiliates appear to have earned routine returns based on the functions they performed. The CFC acting as principal undertook the entrepreneurial risk of the venture and had the intangible property rights necessary to the success of the venture; on that basis, it received a residual return. In other words, in general the residual profits of the venture (say, the business outside the United States) after ensuring a routine return to all functions of affiliates (typically under one-sided

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transfer-pricing method analyzing the affiliates as tested parties) were allocated to the principal. Substantial sums were paid back to the United States in the form of a royalty or, in the context of cost sharing arrangements, the buy-in payment along with annual cost sharing (R & D funding) payments. Notwithstanding these payments, significant amounts remained with the regional principal and/or the foreign intangible property holder.[71] These entities invariably were subject to low rates of local tax.

A full discussion of the technical transfer pricing issues raised by these examples is beyond the scope of this article and in any event would require a more detailed understanding of the facts than that presented by the JCT. Some observations, however, can be made. Notably, there are at least two types of income shifting that may be at play in each example.

> To the extent policymakers are concerned with disproportionate income shifting *per se*, such concerns can only be addressed through fundamental approaches that either supplement or replace the arm's-length standard with a different standard, or by fundamentally altering the current incentives on U.S. MNCs to shift income.

First, the foreign principal in each case is using or exploiting intangible property initially developed in the United States.[72] Licensing or otherwise providing such intangible property to the foreign principal will necessarily shift some income from the intangible to the foreign principal under any application of the arm's-length standard that respects the transfer of the property and attendant economic risks. Taxpayers are likely to take the view that a significant portion of the nonroutine returns from the intangible property should be derived by the foreign principal, particularly in a cost-sharing arrangement where the foreign principal takes on the obligation to fund future intangible development. Taxpayers may also take the view that a significant element of the outbound transfer may be foreign goodwill or going concern value, which is not compensable.[73] The IRS has expressed the view that if the key intangible property to be exploited in foreign markets originated in the United States, then the consideration owing to the transferor should equal all nonroutine returns from the foreign venture, in perpetuity, expected at the time of the outbound transfer.[74] The IRS also has taken a dim view on efforts to hive off some of this value as foreign goodwill or going concern value.[75] Even under the IRS view, however, routine returns on the investment in further developing and exploiting the intangible property will be shifted. Moreover, it is not clear the extent to which the IRS position reflects current law.[76] Finally, in many cases foreign intangible property, such as foreign marketing intangibles, is likely to be present, thereby necessitating an analysis of the extent to which returns are derived from U.S.-originated intangible property.

Second, income from the manufacturing or distribution operations of affiliates may be shifted to the foreign principal to the extent the foreign principal is allocated, and bears, the entrepreneurial risks from such operations. Such a structure could be established at the outset of the business venture or through a business restructuring, in which case the remaining routine manufacturing or distribution function may not be owed any additional return to compensate it for the loss of profit potential.[77] Note that this could also be viewed as a shift of income from the U.S. affiliate if the baseline was a structure under which the U.S. affiliate had kept (or taken) the opportunity to act as a worldwide principal, with all foreign affiliates earning a routine functional return.[78]

In each case study, the JCT report highlights that the relative foreign profits of the MNE exceeded the relative foreign sales of the MNE. Further, in each case study, the effective rate of tax on foreign income was relatively low (although not lower than the effective rate of tax on U.S. income in all cases).[79] The emphasis on the ratios of profits and sales suggests that the concern of the JCT with such structures was primarily U.S.-to-foreign income shifting (where income is "shifted" from the United States to a foreign jurisdiction) through the migration of intangibles and the allocation of risk, and not foreign-to-foreign income shifting. The companies themselves were in various industries and experienced various levels of success; several of the companies had strong performance, with overall operating margins (the ratio of operating margins to sales) as high as 30 percent over multiple years, while others had more ordinary performance.[80]

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Based on the summary facts presented by the JCT and the fact-intensive nature of transfer-pricing analysis, it is not possible to determine with certainty the extent to which each case study illustrates compliant behavior or more questionable behavior. What is clear is that the transfer-pricing planning engaged in by the companies resulted in a shift of income outside the United States as compared to a baseline where the U.S. parent would exploit intangible property directly, and act as a principal, in the arrangement, and that this shift resulted in higher operating margins outside the United States as the profits shifted likely were not proportional to any shift in costs.

Income Shifting Due to Compliant, Rather Than Inappropriate, Transfer Pricing Practices

Under current law, transfer pricing practices consistent with the arm's-length standard can lead to income disproportionate to other economic factors, such as payroll, sales or PPE. This result is possible for a variety of reasons, including the ability of U.S. MNEs to allocate business opportunities and shift income through the transfer of assets and the incident allocations of risk. The implicit baseline used by policymakers and commentators in this area who conclude that the empirical outcomes summarized above must be attributable to inappropriate transfer pricing is the allocation of profits on a formulary basis based on sales or other factors, rather than transfer-pricing planning consistent with the arm's-length standard.

The empirical work summarized above demonstrates that some CFCs of U.S. MNEs earn relative profits that are disproportionate to the payroll, sales, or PPE. These results are inevitable, however, so long as (1) U.S. MNEs are taxed on income and not on some other basis such as sales or payroll, and (2) income is allocated among members of the group using an arm's-length standard that respects the transfer of assets and contractual allocations of risk. Under such a standard, it would be expected that different members of a controlled group would earn different returns as measured against sales, payroll, or PPE. Such an imperfect correlation is present in stand-alone company data as well and therefore may not suggest anything about income shifting due to inappropriate or abusive transfer pricing. As an example, the operating margins in leading companies within industries, as well as industry averages, vary considerably.[81] This is the case, albeit to a somewhat lesser extent, for returns on assets as well.[82] Similarly, three of the companies in the JCT report are very profitable as measured against revenues, while the other three have more average profitability. Some of these differences may be a result of the different business models and other attributes prevalent in certain industries or among certain companies. To the extent different business models are replicated among the members within a controlled group, one would expect different rates of return.

The empirical work summarized above also demonstrates that the profitability of CFCs are inversely correlated with taxes. Again, this is inevitable under our current system as reasonably applied by U.S. MNEs. To the extent that higher margin opportunities can be allocated, it would be expected that such opportunities would be allocated to CFCs operating in low-tax environments. U.S. MNEs would be expected to engage in proactive, tax sensitive transfer pricing practices to manage their overall tax burdens.

Notwithstanding the fact that transfer pricing practices consistent with the arm's-length standard likely account for some of the income-shifting phenomenon, it would be difficult to show the extent the observed income shifting is due to such practices or due instead to more dubious behavior. It is not clear whether this matters. To some, the negative effects of income shifting may not depend on whether they are caused by appropriate or inappropriate transfer pricing under current principles, and therefore should be addressed directly. To others, only income shifting due to inappropriate transfer pricing practices under current principles needs to be addressed, although in practice it may be difficult to develop targeted solutions. A third path is to consider further refinements to the U.S. transfer-pricing rules, consistent with the arm's-length standard, to address income shifting at the margins.

Should Policymakers Be Concerned with Income Shifting?

Income shifting of the type evidenced in empirical work and the JCT case studies can arise from transfer-pricing policies that are consistent with current law or that push the envelope of current law. Is such income shifting, particularly to the extent consistent with current law, a problem, and, if so, why? Defining more precisely the nature of the problem can assist in evaluating potential solutions. For example, if income shifting regardless of cause leads to undesirable results, then policymakers should focus on broad proposals that counteract income shifting without regard to

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whether it is caused by compliant or inappropriate transfer-pricing practices. If income shifting leads to undesirable results only to the extent it is caused by transfer-pricing practices not consistent with the arm's-length standard, then policymakers should focus on proposals that counteract such inappropriate transfer pricing practices.

Income Shifting and the Migration of Jobs

A frequent objection to income shifting relates to the incidental migration of jobs or other activities outside the United States. Commentators sometimes characterize the ability to shift income to low-tax environments as reducing the marginal tax burden on foreign investment (and incident foreign jobs), to the detriment of U.S. investment (and incident U.S. jobs).[83] Commentators have characterized the allowance of income shifting as a "subsidy" in favor of foreign investment.[84]

Disproportionate income shifting without attendant shifting of payroll, activities or tangible assets of course has no direct effect on jobs. To the extent such pure income shifting is permitted at the margin under the current rules and available to some companies or industries, it operates as a "subsidy" for all investment and job creation by such companies or industries, not just foreign investment or job creation. In other words, to the extent that U.S. MNEs are able to shift to lower tax environments income associated with U.S. activities, the "subsidy" due to the lower-tax burden arguably supports those U.S. activities (and incidental employment).

In many cases, however, a shift of income is accompanied with some shift of other economic factors, including jobs and investment, in part to justify the shift of income.[85] While the movement of jobs or investment may be relatively small compared to the shift in income, the aggregate effects over all U.S. MNEs may be significant. It would be difficult to quantify such effects. Indeed, the empirical data work against opponents of income shifting in this context; the greater the ratio of income-to-payroll or employment in low tax affiliates of U.S. MNEs, the more difficult it is to argue that income shifting is contributing significantly to a migration of jobs outside the United States.

Other aspects of the current U.S. tax system, notably the tax on repatriation, may operate to create an incentive towards foreign investment once income has been shifted to low-tax jurisdictions and begins to accumulate. The marginal cost of investing such funds outside the United States is lower than investing it in the United States. If this is a concern, it is not clear that focusing on income shifting is necessarily the appropriate policy response; the same dynamic is created by the accumulation of deferred foreign active business income whether it has been shifted or not, or whether the shifting is consistent with the arm's-length standard or not.

Income Shifting and the Equitable Distribution of the Corporate Tax Burden

A more basic objection to income shifting is on the basis of fairness or equity. The U.S. corporate tax system in general applies a uniform rate to all net income earned by U.S. corporations, and all net income attributable to a permanent establishment or trade or business of foreign corporations. Income-shifting techniques that are available to some, but not all, taxpayers or industries may be cause for systemic concern. The U.S. transfer pricing system permits some flexibility in the allocation of business opportunities and expected returns to risk, including entrepreneurial risk and the risk of intangible property development. Taxpayers with higher margins attributable to such risks, or with a greater ability to separate risks from attendant economic factors, will tend to benefit more from the income shifting possible under current rules than other taxpayers.

A fairness analysis raises the question of the appropriate baseline. If the arm's-length standard as currently implemented in the U.S. transfer pricing rules provides the appropriate baseline, then fairness concerns are raised only by income shifting due to inappropriate transfer pricing practices. If instead the baseline assumes uniform returns to sales or PPE, then fairness concerns are raised by income shifting regardless of cause.

Income Shifting and the Erosion of the U.S. Tax Base

Another objection to income shifting is that income shifting results in an erosion of the U.S. tax base. This objection is similar to the fairness objection, with a focus on the U.S. fisc rather than other taxpayers. Again, the issue here is the appropriate baseline. If the U.S. tax base is defined in part on the basis of the arm's-length standard as currently implemented in the U.S. transfer pricing rules, then base erosion concerns by definition are raised only by income shifting due to

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inappropriate transfer pricing practices. If instead the U.S. tax base is defined based on a more formulaic basis with reference to uniform returns to sales or PPE, then base erosion concerns are raised by income shifting regardless of cause.

An additional consideration in this context is the relatively high U.S. corporate tax rate. To the extent the current rules permit some flexibility in the allocation of income, then the U.S. fisc will not fare well as income will tend to be allocated away from the United States.

If Income Shifting Is a Problem, Do Current Proposals Offer Reasonable Solutions?

A variety of international tax policy proposals in recent years have been motivated in whole or in part by the income-shifting phenomenon. This part outlines a handful of these proposals, and analyzes them based on the preceding discussion. In particular, each proposal is assessed in terms of whether it would address income shifting *per se,* or whether it would focus on income shifting that results from transfer pricing practices inconsistent with the arm's-length standard. This part also discusses several more fundamental proposals that might be elements of future tax reform and assesses the impact of each on income shifting, including whether the proposal would materially alter the incentive of U.S. MNEs to shift income.

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Proposals Targeted at Transfer Pricing Practices Arguably Inconsistent with Current Standards

Two recent reform proposals would modify current transfer pricing rules to prevent practices that are likely perceived by the IRS as inappropriate under current law. Each of these proposals would retain the arm's-length standard but would put new restrictions on the ability of U.S. taxpayers to shift income to foreign affiliates by transferring intangibles or allocating risk.

Modifications Related to Transfers of Intangibles

The Administration's 2011 Budget proposes to "limit shifting of income through intangible property transfers."[86] This proposal would expand the scope of compensable intangible property for purposes of Code Secs. 367(d) and 482 to include goodwill, going concern and workforce-in-place. The proposal would also codify certain approaches to valuing intangible property. In particular, the proposal permits the IRS to value intangibles on an aggregate basis in cases where an aggregate valuation of multiple transferred intangibles "achieves a more reliable result," and permits the IRS to value intangibles based on the prices or profits that could have been realized if the taxpayer chose a "realistic alternative" to the related-party transfer of the intangibles.

This proposal appears intended to address transactions under current law where the taxpayer attributes significant value of foreign business operations or assets transferred outside the United States to goodwill and going concern value that escapes current taxation under Code Sec. 367(a)(3) or general principles.[87] Because the proposal is described as a clarification, however, the extent to which it is intended to change the historical scope of the active business exception for outbound transfers is unclear.[88] Currently, Code Sec. 367(d) provides a limited exception from the rule permitting tax-free outbound transfers of active business assets by taxing transfers of identifiable intangible property. This exception was intended to prevent taxpayers from deducting intangible development costs and then shifting related income to a deferral vehicle if the development is successful and the intangible property becomes exploitable. [*See* H.R. Rep. No. 98-432, 1316 (1984).] Extending the definition of intangible property to include goodwill, going-concern value, and workforce-in-place could have a significant impact on transfer-pricing planning under current law. This would be the case in particular if the regulatory exception from Code Sec. 367(d) for foreign goodwill and going-concern value is eliminated. Because foreign goodwill and going-concern value typically represent the present value of future active business income earned from both tangible and intangible assets, the taxation of foreign goodwill and going concern could effectively accelerate recognition of active business income. If the proposal operates in this way, it would appear to prevent the shifting of future active business income rather than merely the shifting of income attributable to identifiable intangibles, and therefore represent a fundamental change in policy in this area. It is important to acknowledge, however, that such policies are grounded in the nonrecognition rules of Code Secs. 351 and 367(a), and not in the arm's-length standard. Under a pure implementation of the arm's-length

standard, cross-border transactions between related parties generally would not be treated as tax-free except to the extent such transaction would be so treated if undertaken by unrelated parties.

In light of the description of the proposal as a clarification (as well as its modest revenue score), however, the proposal may envision the retention of the current law exception from Code Sec. 367(d) of foreign goodwill and going-concern value. Thus, the proposal would operate where that exception would not. For example, the proposal would ensure taxation of outbound transfers of U.S. goodwill or going-concern value and of workforce-in-place whether U.S. or foreign. This would have the effect of codifying current IRS litigating positions, which are controversial. The valuation aspects of the proposal similarly would have the effect of codifying current IRS litigating positions regarding the valuation of a portfolio of intangible assets on a aggregate basis rather than on a stand-alone basis.

Importantly, under either reading, this proposal does not purport to change the fundamental operation of the arm's-length standard. Thus, presumably no charge would be required for transactions for which there would be no compensation at arm's length, consistent with existing case law. This proposal can be viewed as making more explicit, and extending in some cases, the scope of potentially taxable or compensable transactions under the current system as a way to target income shifting due to transfer-pricing practices that are either inappropriate or perceived to be so under current standards.

Restrictions on Respect for Contractual Allocations of Risk

Another recent policy proposal would amend the transfer pricing rules to "exclude allocation of income away from a U.S. affiliate to a foreign affiliate based on the risk borne by that foreign affiliate's capital."[89] This proposal would depart from current law, which respects contractual allocations of risk so long as the risk-bearing CFC is capable of bearing the risk and the transaction is therefore consistent with economic substance. Under the proposal, the ability to allocate risk would be retained in the case of transfers to CFCs in U.S. tax treaty partner countries and in nontreaty countries that are significant U.S. trading partners.

This proposal is intended to reflect the observation that when the capital of a CFC bears risk under a contractual allocation, this risk represents the risk of the U.S. shareholder that provided the capital to the foreign affiliate. In that respect, the proposal violates a central tenent of the arm's-length standard, which ignores the control relationship in attempting to arrive at an economically sound allocation of income. The proposal thus would prevent shifting of income to CFCs in transactions that are respected as resulting shifts of expected income under current transfer pricing rules.

To the extent the proposal is limited only to contractual allocations of risk to CFCs without significant direct business operations (including, for example, employees with authority and capacity to understand and manage the risks undertaken) that are operating in very low or no-tax environments, however, it can be viewed as a modest refinement of the arm's-length standard to aid in the administration of the standard. Such risk allocations under current law are likely to attract scrutiny and may not meet regulatory standards. [*See* Reg. §1.482-1(d)(3).] This proposal can be viewed as refining those standards to ease enforcement and therefore to target income shifting due to transfer pricing practices that are either inappropriate or perceived to be so under current standards.

Proposals Targeted at Income Shifting More Generally

Unlike the transfer pricing proposals discussed above, other current proposals appear intended to address and mitigate income shifting even in circumstances where the arm's-length standard, as appropriately applied, is met. These proposals would curtail income shifting without regard to whether it arose due to inappropriate transfer pricing practices, and can therefore reduce or even eliminate the role of the arm's-length standard.[90] In this regard, these proposals raise much more significant policy issues.

Excess Returns Proposal

The Administration's 2011 Budget proposed to "tax currently excess returns associated with transfers of intangibles offshore."[91] This proposal addresses income shifting by creating a new category of Subpart F income. Under this proposal, if there is an outbound transfer of intangible property to a related CFC that is subject to a "low foreign effective tax rate" in circumstances that evidence "excessive income shifting," then the amount of the "excessive return" is treated as Subpart F income. This Subpart F income would be placed in a separate basket for foreign tax credit purposes.[92]

The proposal is not fully developed and raises a number of definitional and technical issues that are as yet unanswered. For example, the proposal may

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envision that the statute would specify a threshold "low effective tax rate" and would define an "excessive return" based on returns on investment or returns on risk.[93] It is not clear whether the excessive return needs to be factually related to the intangible property that was transferred; if not, it is not clear conceptually why an intangible transfer is a necessary prerequisite to the application of the rule. Additionally, it is unclear whether the fact of a return above some threshold would itself evidence "excessive income shifting," or whether a taxpayer could show that, under the facts and circumstances, returns were not excessive. There are no obvious policy solutions to some of these definitional questions. On the one hand, objective standards and thresholds would be arbitrary, and one the other hand, subjective standards that look to facts and circumstances may be difficult to administer.

More significantly, however, the proposal raises significant conceptual issues. The proposal is justified with reference to a "significant erosion of the U.S. tax base" that has resulted from income shifting through intangibles transfers that put "significant pressure on the enforcement and effective application of transfer pricing rules."[94] The proposal therefore might be intended to address perceived deficiencies in the current transfer pricing system. The suggestion, however, that an intangible transfer might generate "excess returns" notwithstanding an *ex ante* valuation that complied with arm's-length pricing indicates discomfort with the arm's-length standard itself. Furthermore, although Subpart F traditionally has played a role as a backstop to the transfer pricing rules, the focus of the excess returns proposal on overall profits, rather than income from categories of transactions, is novel.

Because the excess profits proposal would define excess profits by formula and would tax these excess profits without regard to whether intangibles were transferred at an arm's-length price, the proposal appears to reject the arm's-length standard and current transfer pricing principles to the extent they could lead to returns above a certain threshold in specific CFCs. Rather than targeting inappropriate practices that exist under the current rules, this proposal restricts income shifting regardless of its cause, even in circumstances where the taxpayer's transfer pricing is fully compliant with current standards.

Formulary Apportionment

Many academics and other commentators have proposed a "formulary apportionment" system whereby profits are apportioned within a multinational group based on objective economic factors such as sales, payroll, or assets. Such a system is already in use among U.S. states. One such proposal would assume a routine arm's-length return on activities of the related affiliates and then allocate the residual profits in accordance with sales.[95]

Formulary apportionment would be a significant departure from the arm's-length standard, and if unilaterally implemented, would invariably result in double taxation because of inconsistencies between countries that use the arm's-length standard and countries that use formulary apportionment (or between countries that use different formulas).[96] Formulary apportionment would also reach arbitrary results in many cases because it ignores intangible property and allocations of risk, two factors that drive returns among independent parties.[97] Furthermore, depending on the factors used in the formula, formulary apportionment could create an incentive to shift actual economic activities out of the United States and thereby contribute to off-shoring of jobs. In this regard, the proposal to allocate residual returns based on sales has some appeal, notwithstanding the fact that it would be difficult economically in many industries or under many business models to conclude that residual profits should be taxed in the market country.

A formulary apportionment proposal would mark the end of the arm's-length standard and target income shifting without regard to whether the income shifting arose from inappropriate or abusive transfer-pricing practices under current principles. It would fundamentally alter the U.S. corporate income tax base for MNEs, and should be considered in that light.

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Tightening Traditional Subpart F Rules

The Subpart F reform proposals described below are intended to address the foreign principal structures of the type highlighted in the JCT Income Shifting Report. Consistent with the traditional Subpart F rules, these proposals apply without regard to whether the targeted transactions are priced consistently with the arm's-length standard. These proposals would result in the current taxation of active business income earned by CFCs, and thus further move the U.S. system away from international norms.

Repeal look-through for foreign-to-foreign royalties. One recent proposal would require current taxation of royalties and other income from intangibles received from a CFC.[98] The proposal would extend Subpart F to royalties paid by a CFC to a related CFC (by repealing the Subpart F look-through

rule for royalties) and provide that royalties received from a disregarded entity are taken into account as royalties for purposes of Subpart F. The proposal furthermore would deem sales income to be Subpart F income if any intangible property used in production by a CFC was "made available" to the CFC by a related U.S. person. This latter rule would not apply, however, to property produced directly by a CFC and not by a disregarded entity.

This proposal is aimed at preventing U.S. MNEs from shifting income from high-tax jurisdictions (including the United States in the case of certain intangible property transfers) to low-tax foreign jurisdictions. It operates without regard to whether such income shifting transactions are priced consistently with the arm's-length standard.

Limit deferral to "same country" earnings. Another recent proposal aimed at curtailing deferral would have required U.S. shareholders of a CFC to include in income their *pro rata* shares of almost all of the CFC's income.[99] This proposal would have provided exceptions for services income derived in the active conduct of a business servicing customers in the CFC's country of residence, income from the manufacture of property within the CFC's country of residence, and income from the resale in the CFC's country of residence of property manufactured in that country of residence.

This proposal is aimed at preventing U.S. MNEs from shifting income from the United States and other high-tax jurisdictions to low-tax foreign jurisdictions. It operates without regard to whether such income shifting transactions are priced consistently with the arm's-length standard.

Potential Tax Reform Proposals

Certain more fundamental proposals that might be elements of future tax reform would have an impact on income shifting, including with respect to the incentives of U.S. MNEs to shift income.

Full Inclusion System

Ending deferral and moving to a full inclusion system would be an effective way to eliminate virtually any tax incentive to shift income from the U.S. to foreign jurisdictions or from high-tax to low-tax foreign jurisdictions because U.S. MNEs would be subject to tax on worldwide income at U.S. tax rates.[100] Unless coupled with a drastic cut in the U.S. corporate tax rate, however, ending deferral would present a radical departure from the current system and from current international trends in favor of territoriality, and would exacerbate the precarious competitive positions of U.S. MNEs in light of other economic trends.

Territorial System

In a territorial system, active business income earned by foreign subsidiaries and perhaps foreign branch operations would not be subject to U.S. tax either when earned or repatriated. Some policymakers, including most recently the chairs of the Administration's deficit reduction commission, have suggested that a territorial system, with continued taxation of passive foreign-source income under Subpart F, would improve competitiveness and bring the U.S. system more in line with those of our international trading partners.[101] A move to a territorial system could increase the incentive to shift income outside of the United States, however, because income shifting would lead to permanent tax benefits. Given the opportunity for income shifting and the incentives to maintain deferral of foreign income under the current system, including the financial reporting treatment of amounts permanently reinvested abroad consistent with an indefinite deferral, it is possible that the incentives under a territorial system would not produce a marked increase in income shifting by some U.S. MNEs. Further, the adoption of a territorial system might reduce the incentive to shift income in certain cases.[102]

Lower Corporate Tax Rate

A significant reduction in the U.S. corporate tax rate (also recommended by the chairs of the Administration's deficit reduction commission) would reduce incentives to shift income outside the United States. Such a reduction might take the form of an overall reduction in rates or simply a reduction in the tax rate on certain categories of income, such as income from royalties. A reduction in corporate tax rates would be consistent with international trends and could improve the competitiveness of the U.S. economy, but the proposal raises the important question of how the resulting revenue shortfall would be made up. Further, while a reduction in the U.S. corporate tax rate consistent with international norms would mitigate the incentive to shift income, it would not eliminate such incentive unless the reduction were drastic.

Conclusion

U.S. MNEs can and do use transfer pricing practices to allocate taxable income to low-tax foreign affiliates that is disproportionate to other economic factors,

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such as sales, payroll or PPE. The policy conclusions that may be drawn from this observation, however, are limited. This income-shifting phenomenon is attributable to some extent to transfer pricing practices that are consistent with the arm's-length standard. Refining the U.S. transfer pricing rules at the margin to make them more robust or consistent with IRS litigating positions will not end income shifting that is clearly permissible under any articulation of the arm's-length standard that fundamentally respects allocations of business opportunities, transfers of intangible property and other allocations or risk within the group. The policy justification for addressing income shifting that results from transfer pricing practices consistent with the arm's-length standard have not been well articulated. To the extent policymakers are concerned with disproportionate income shifting *per se,* such concerns may best be addressed through fundamental approaches that either supplement or replace the arm's-length standard with a different standard, or by fundamentally altering the current incentives on U.S. MNEs to shift income.

ENDNOTES

[1] *See, e.g.*, Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG (Oct. 21, 2010); Martin A. Sullivan, *Drug Company Profits Shift Out of United States*, 126 TAX NOTES 1163 (Mar. 8, 2010); Glenn Simpson, *Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe*, WALL ST. J., Nov. 7, 2005, at A1.

[2] *See, e.g., Veritas, Inc.*, 133 TC 297 (2009) (deficiency of over $2 billion). The issue in *Veritas* involved the appropriate pricing of a "buy in" payment in the context of a cost sharing arrangement for the development of intangible property. As of 2007, IRS officials estimated that there was $23 billion at stake in current disputes with taxpayers involving this issue. *See* Mitchell J. Tropin, *IRS Planning Cost Sharing Issues Paper, May Lead to Appeals Settlement Guidelines*, 15 BNA TRANSFER PRICING REP. 766 (Mar. 7, 2007).

[3] In the United States, comprehensive transfer pricing regulations were finalized in 1994, and regulations addressing cost sharing arrangements were finalized in 1995. Regulations addressing services transactions were finalized in 2009 (following on virtually identical temporary regulations from 2006), and new temporary regulations addressing cost sharing arrangements were finalized in 2009 as well.

[4] Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (hereinafter, "2011 Green Book"), at 43 (Feb. 2010).

[5] Code Secs. 1 and 11.

[6] Code Sec. 864.

[7] *See, e.g., Eisner v. Macomber*, SCt, 1 USTC ¶32, 252 US 189 (1920).

[8] *See* Code Secs. 951–64.

[9] *See* Code Secs. 951(a)(1)(A) and 954.

[10] *See generally* Code Secs. 954(d) (implicitly excepting from Subpart F income products manufactured by the CFC, as well as local country sales); 954(e) (excepting from Subpart F income from local country services); 954(c)(2)(A) (excepting from Subpart F active rents and royalties); and 954(h) (excepting from Subpart F active financing income).

[11] *See* Code Sec. 954(c)(6).

[12] *See* Notice 98-11, 1998-1 CB 433 (describing check-the-box planning in this context).

[13] *See* Code Secs. 951(a)(1)(B) and 956.

[14] *See* Code Secs. 901, 902 and 906.

[15] *See* Code Sec. 904(a).

[16] *See* Code Sec. 861(a) and (b).

[17] *See* Code Sec. 864(e) (allocation of interest expense) and 864(g) (allocation of research and experimentation expenses).

[18] *See* Code Sec. 904(d).

[19] *See* Code Sec. 482 and the regulations thereunder.

[20] *See* Reg. §1.482-1(b).

[21] *See* Code Sec. 482.

[22] *See* Reg. §§1.482-4(f)(2) and -7T(i)(6).

[23] *See* Reg. §1.482-7T.

[24] *See First Security Bank of Utah*, SCt, 72-1 USTC ¶9292A, 405 US 394 (1972); *but see* Reg. §1.482-1(h)(2) (limiting this principle for certain foreign legal restrictions).

[25] *See, e.g., H Group Holdings, Inc.*, 78 TCM 533, Dec. 53,575(M), TC Memo. 1999-334 (1999) (reassignment of an employee (or a group of employees) within a controlled group does not give rise to a compensable transaction).

[26] *See Hosp. Corp. of Am.*, 81 TC 520 (1983); *Merck & Co.*, ClsCt, 91-2 USTC ¶50,456, 24 ClsCt 73 (1991).

[27] *See* Reg. §1.482-1(d).

[28] *See* Reg. §1.482-1(d)(3)(iii)(B).

[29] *See* Reg. §1.482-1(d)(3)(ii)(B), (iii)(B); (f)(2)(ii).

[30] *See* Reg. §1.482-1(c).

[31] *See* Reg. §1.482-1(c)(2)(iii).

[32] *See, e.g., Nat'l Sec. Corp.*, CA-3, 43-2 USTC ¶9560, 137 F2d 600; *see also* Reg. §1.482-1(f)(iii).

[33] *See* Code Sec. 367(a)(3)(A).

[34] *See* Code Sec. 367(a)(3)(B) and 367(d); *see also* Code Sec. 936(h)(3)(B) (defining intangible property).

[35] *See* Reg. §1.367(a)-5T(e).

[36] *See* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) ("OECD Guidelines"). Members of the OECD have endorsed the OECD Guidelines in the context of resolving transfer pricing disputes under bilateral income tax treaties.

[37] *See* OECD Guidelines, Chapter IX: Transfer Pricing Aspects of Business Restructuring (2010).

[38] *See* OECD, OECD Invites Comments on The Scoping of Its Future Project on the Transfer Pricing Aspects of Intangibles, July 2, 2010 at *www.oecd.org/document/55/0,3343,en_2649_33753_45565303_1_1_1_1,00.html.*

[39] Patent box regimes exist in Belgium, France, Ireland and the Netherlands. The United Kingdom recently announced an intention to introduce a patent box regime in April 2013. *See* HM Treasury, Corporate Tax Reform: Delivering a More Competitive System (Nov. 2010).

[40] The combined federal and sub-federal corporate income tax rates in Canada, Germany, and the United Kingdom are at or below 30 percent, which is significantly less than the comparable U.S. rate of 39 percent. *See* OECD Tax Database at *www.oecd.org/ctp/taxdatabase.*

[41] For example, the average federal and sub-federal corporate income tax rates in the G7 countries other than the United States declined from 45 percent in 1990 to 32 percent in 2010. *See* OECD Tax Database at *www.oecd.org/ctp/taxdatabase.*

[42] Code Sec. 864.

[43] Code Sec. 881.

[44] *See* Code Sec. 902(a) (limiting indirect foreign tax credit to deemed taxes paid by U.S. corporations).

[45] *See* 2000 Fortune Global 500 and 2009 Fortune Global 500.

[46] Based on World Bank data, the U.S. share of world GDP in 2000, 31.1 percent, had declined approximately 21 percent to 24.4 percent by 2009.

[47] *See* IMF World Economic Outlook, Table 1.1 at 2 (Apr. 2010) (forecasting significantly

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higher rates of GDP growth in 2011 for China (9.9 percent), India (8.4 percent), and Brazil (4.1 percent) than for the United States (2.6 percent).

[48] This is not uniformly the case. Some commentators use the term to encompass income shifting from at least some compliant transfer-pricing practices. *See, e.g.,* Martin A. Sullivan, *Transfer Pricing Abuse is Job-Killing Corporate Welfare*, 128 Tax Notes 461 (Aug. 2, 2010): "Inappropriate" here means the perfectly legal but economically indefensible assignment of profits to subsidiaries in low-tax jurisdictions."

[49] For summaries of this work over the last 20 years, *see* U.S. Dep't of the Treasury, Report to Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties, 59–60 (Nov. 2007), and J. Comm on Tax'n, Present Law and Background Related to Possible Income Shifting and Transfer Pricing,at 6–9 (July 20, 2010) (JCX-37-10) (hereinafter "JCT Income Shifting Report").

[50] *See* Martin A. Sullivan, *Transfer Pricing Costs U.S. at Least $28 Billion*, 126 Tax Notes 1439 (Mar. 22, 2010); *see also* Government Accountability Office, U.S. Multinational Corporations, Effective Tax Rates are Correlated with Where Income is Reported, Report to the Committee on Finance, U.S. Senate 25–26 (Aug. 2008) (showing a significant increase in profits in foreign affiliates in 2004 relative to other economic factors) (hereinafter "GAO Report").

[51] *See* Martin A. Sullivan, *Transfer Pricing Abuse is Job-Killing Corporate Welfare*, 128 Tax Notes 461 (Aug. 2, 2010); *see also* GAO Report, at 29–31 (showing similar results).

[52] *See* Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data*, OTA Technical Working Paper 2 (July 2008).

[53] *Id.*, at 16.

[54] *Id.*, at 19.

[55] *See* Harry Grubert, *Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad*, Oxford University Centre for Business Taxation, WP 09/29 (Sept. 2009).

[56] *Id.*

[57] *See* Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data*, at 19: "It is important to recall again that these results do not in themselves necessarily point to transfer pricing abuse as the underlying cause of the inverse relationship between tax rates and profitability. The data are aggregated beyond the transactional level necessary for such a determination, and in addition there were no transfer pricing specific regressors to evaluate."

[58] There is anecdotal evidence that U.S. MNEs sometimes incur unexpected losses in low-tax affiliates following the shift of operations and incident business risks. *See, e.g.,* James Bandler and Mark Maremont, *How a Xerox Plan to Reduce Taxes and Boost Profit Backfired*, Wall St. J., Apr. 17, 2001, at C1 (describing the negative tax effect of business losses by a U.S. MNE following a shift of operations and attendant risks to Ireland).

[59] *See* Testimony of Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, Before the U.S. House Committee on Ways and Means, at 7–9 (July 22, 2010).

[60] *See id.* ("We continue to believe that the arm's-length standard provides the appropriate basis for clearly reflecting income among affiliates. … However, we have been, and we continue to be, very concerned about income shifting from non-arm's length transfer pricing.") (Emphasis added.)

[61] *See, e.g.,* Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, 62 Nat'l Tax J. 736 (Dec. 2009): "There is ample, and readily understandable, evidence of profit shifting to low-tax countries that is inconsistent with an economic motivation."

[62] *See* Statement of James R. Hines, Jr., Testimony Before the Committee on Ways and Means, at 7–9 (July 22, 2010): "Evidence of the impact of transfer pricing on U.S. tax collections is surprisingly limited."

[63] The reaction of practitioners in the area to this rather benign conclusion likely will be akin to the shock expressed by Captain Renault to find gambling at Rick's. Casablanca, 1942.

[64] *See, e.g.,* Rev. Rul. 72-312, 1972-1 CB 22 (transferor of bonds to trust is taxed on interest accrued on bonds before transfer, notwithstanding receipt of interest by trust, but interest accruing after transfer is included in trust's gross income). *Helvering v. Horst*, SCt, 311 US 112 (1940) (interest paid to donee of coupons taxed to donor where donor retained the income-producing bond).

[65] One common way of shifting income is through debt funding. A discussion of this mechanism for shifting income, which is subject to legal restrictions such as thin-capitalization rules that are beyond the transfer pricing rules, is beyond the scope of this article.

[66] *See Merck & Co.*, ClsCt, 91-2 ustc ¶50,456, 24 ClsCt 73, 88 (1991): "A parent corporation may create subsidiaries and determine which among its subsidiaries will earn income." *Bausch & Lomb,* 92 TC 525, 593 (1989), *aff'd,* CA-2, 933 F2d 1084 (1991): "There mere power to determine who in a controlled group will earn income cannot justify a section 482 allocation of the income from the entity who actually earned the income."

[67] *See* OECD Guidelines ¶9.65: "An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits."

[68] Such controversies can involve hundreds of millions or even billions of dollars of tax. In *Veritas, Inc., supra* note 2, for example, the IRS asserted a deficiency of over $2 billion. The Tax Court held in favor of the taxpayer.

[69] *See* JCT Income Shifting Report.

[70] *See* JCT Income Shifting Report, at 103–09.

[71] In case study Bravo, for example, the foreign principal had average annual gross receipts of $60 billion and average U.S. E & P of $20 million. Payments to its U.S. affiliate included $6 billion for support services, $9 billion to help fund R & D, and several billion dollars in royalties over four years at the start of its cost sharing arrangement.

[72] *See* JCT Income Shifting Report, at 105–06.

[73] In case study Charlie, for example, the taxpayer attributes almost all of the value of foreign business operations transferred outside the United States during the review periods to foreign goodwill and going concern value.

[74] *See, e.g.,* Preamble to 2009 Temporary Cost Sharing, 74 FR 340, 345 (Jan. 5, 2009) (describing application of income method to transfer of intangible property in the cost sharing context, where the transferor derives all returns from the intangible property to be developed in the cost sharing arrangement following the allocation of routine returns to the transferee).

[75] *See* TAM 200907024 (Nov. 10, 2008) (concluding that the synergistic value of a network of foreign contractual arrangements transferred outside the United States in the context of a global delivery business was attributable to the contracts and therefore taxable under Code Sec. 367(d), rather than noncompensable foreign goodwill or going concern value.)

[76] In *Veritas, Inc., supra* note 2, for example, the Tax Court rejected the position of the IRS, characterizing the position as valuing the outbound transfer of intangible property as if it were "akin" to the outbound transfer of the entire foreign business notwithstanding that significant elements to that business were not transferred.

[77] *See* OECD Guidelines ¶9.65: "An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits."

[78] Case study Alpha provides a good example of this type of income shifting. In case study Alpha, significant profits are booked by two foreign principals, Alpha Asia and Alpha Netherlands, which pay relatively low rates of tax. Routine returns are assigned to high tax affiliates (including the U.S. parent)

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that conduct R & D, manufacturing, and distribution functions with respect to U.S. and foreign sales. *See* JCT Income Shifting Report, at 54-1.

[79] The U.S. effective tax rate on U.S. income was lower than the foreign effective tax rate on foreign income in the cases of Alpha and Charlie. It is not clear why this is the case. *See* JCT Income Shifting Report, at 54-1 and 73-6.

[80] The operating margins of Bravo, Delta, and Charlie were 30 percent, 20 percent and 25 percent, respectively, over multi-year periods; the operating margins of the other case study companies were 10 percent or less. *See* JCT Income Shifting Report, at 54-1, 62-2 and 73-6.

[81] For example, 2008 operating margins among large MNEs in the pharmaceutical industry (19.1 percent) were almost eight times higher than those among large MNEs in the computer hardware industry (2.5 percent). Further, the operating margin of the largest U.S.-based computer hardware company (Hewlett-Packard) was 70 percent higher than that of the second largest (Dell). *See* 2009 Fortune Global 500.

[82] For example, the 2008 return on assets of the largest U.S.-based software company (Microsoft) was more than twice that of the second largest (Oracle). *See* 2009 Fortune Global 500. Wide differences in returns on assets may be attributable in part to the manner in which financial data is kept. For example, nonfinancial companies typically keep assets on their balance sheets at historical cost adjusted for depreciation. For this reason, a company that has grown through acquisitions will tend to have a relatively higher asset base (which often reflects the value of acquired intangible assets including goodwill), and a relatively lower apparent return on assets, than a company that has grown more organically. Distortions of this type abound in financial data.

[83] *See* Martin A. Sullivan, *Transfer Pricing Abuse is Job-Killing Corporate Welfare*, TAX NOTES 467–68 (Aug. 2, 2010): "By allowing inappropriate transfer pricing, the IRS is subsidizing investment in low-tax countries. … This corporate welfare is available only to businesses investing abroad."

[84] *See id.*

[85] *See* Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 5 FLA. TAX REV. 497, 500 (2009) ("the shifting of income involving legal and accounting techniques typically involves moving real activities to low-tax countries").

[86] 2011 Green Book, at 44 (Feb. 2010). This proposal is based on a proposal in the 2010 Budget.

[87] *See, e.g.,* JCT Income Shifting Report, at 73-6; and TAM 200907024 (Nov. 10, 2008).

[88] Joint Comm. on Tax'n, Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal, JCS-2-10, at 279–81 (Aug. 16, 2010).

[89] Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, 35 INT'L TAX J. 5, 94 (Jan.–Feb. 2009).

[90] The propriety of the arm's-length standard has been the subject of considerable discussion and debate over many decades. *Compare* James J. Tobin, Barbara M. Angus, and David J. Canale, *Preserving and Protecting the Arm's-Length Standard*, 19 BNA TRANSFER PRICING REP. 342 (July 15, 2010) (defending the arm's-length standard) *with* Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 5 FLA. TAX REV., at 501–07 (seriously questioning the continuing viability of the arm's-length standard in light of modern business practices).

[91] Green Book, at 43.

[92] The separate basketing of this category of Subpart F income is a punitive result, putting the taxpayer in a worse position than had it initially priced the intangible transfer between the U.S. shareholder and the CFC so as to bring the CFC below the excessive-return threshold.

[93] Officials in the Treasury have stated that for purposes of scoring the proposal, the effective tax rate threshold was set at 10 percent, and the excessive return threshold was set at a 30-percent return on assets. *See* Alison Bennett, *International Provisions in FY 2011 Budget Would Raise $122 Billion, Limit Deferral,* 20 DAILY REPORT FOR EXECUTIVES GG-3 (Feb. 2, 2010); K. Parillo and D. Stewart, *Obama's Budget Drops Check-the-Box Repeal, Adds International Provisions*, 20 TNT 21-3 (Feb. 2, 2010). Both standards were assessed against information contained in current law information reporting with respect to CFCs.

[94] Green Book, at 43.

[95] Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 5 FLA. TAX REV., at 508–10.

[96] If all U.S. MNEs aggressively allocated residual returns to low tax affiliates, the likelihood of double taxation among jurisdictions with relatively high rates of tax would be significantly decreased. *Id.*, at 521.

[97] It may be argued that the arm's-length standard as applied in practice reaches arbitrary results because it does not recognized the integrated nature of modern MNEs and in light of the significant range of possible results, as evidenced by the amounts at stake in transfer pricing disputes. But the arm's-length standard is based on an economic framework that is rational in light of the purposes of the income tax. While the results reached under formulary apportionment may be more certain and predictable, they would be arbitrary in the much more fundamental sense that they would not even attempt to match the siting of income with the functions, assets, and risks utilized to generate such income.

[98] H.R. 5328, the International Tax Competitiveness Act of 2010.

[99] *See* S. 96, the Export Products Not Jobs Act (2007).

[100] Note that there still may be some incentive to shift income to optimize a U.S. MNEs foreign tax credit position.

[101] Nat'l Comm'n on Fiscal Responsibility and Reform, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, at 28–29 (Dec. 2010).

[102] For example, a U.S. MNE that is in an excess foreign tax credit position may have a strong incentive under current law to shift income to low-tax foreign affiliates and reduce its effective rate of foreign tax on foreign source income until its foreign taxes are fully creditable.

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