Chairman Levin, Ranking Member Coburn and members of the Subcommittee, thank you for the opportunity to testify on the important topic of shifting of profits offshore by U.S. multinational corporations. I am a Professor of Practice at Harvard Law School. The views I am expressing are my personal views.

The Subcommittee and its staff should be commended for initiating this important investigation. It comes at a time when the two most urgent priorities for this country are to put more Americans to work and to agree on a credible path to address the structural Federal budget deficit in a manner consistent with increasing jobs and restoring sustainable economic growth. In the face of legislative gridlock, we must protect our existing tax base; indeed, it would be irresponsible not to try to increase revenue where it is consistent with good tax policy. This is good for the deficit and dealing responsibly with the deficit is good for jobs.

The issues highlighted by the Subcommittee staff investigation, relating to transfer pricing and porous rules relating to use of deferred profits in ways not consistent with our deferral regime, are susceptible to immediate action by the executive branch without new legislation and that should be done. But the Subcommittee staff’s work product also highlights the potential for the two parties to work together to strengthen and adopt broadly similar anti-base erosion proposals put forward by the Administration, Chairman Camp and Senator Enzi as deficit reduction measures without waiting for a tax reform process that will take years.

My testimony will provide background information on the taxation of foreign income of U.S. multinationals earned through a controlled foreign corporation and transfer pricing. I then

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1 My testimony is at the request of the Subcommittee, by letter dated September 6, 2012 from Chairman Carl Levin and Ranking Member Tom Coburn. My testimony is in a personal capacity and does not represent the views of Harvard Law School or Harvard University.

2 Prior to my current position, I was the Deputy Assistant Secretary for International Tax Affairs at the Department of the Treasury. Before my most recent government service, I was a tax partner at Ropes & Gray LLP for 22 years specializing in U.S. international income taxation before retiring to serve in government in 2009. I have provided a copy of my biography to the Subcommittee. I occasionally consult for Ropes & Gray LLP on mutually agreed projects.

3 I first served in the U.S. Treasury Department’s Office of Tax Policy from 1982 to 1987. I was actively involved in the development through 1984 of the Reagan Administration’s international tax reform proposals and the legislative consideration of the proposals through signing of the legislation on October 22, 1986. The process took almost three years in total.
will discuss the Subcommittee staff’s case study findings regarding income shifting and the use by a U.S. multinational of its deferred offshore earnings in its U.S. business without paying United States tax on the earnings. I will close with observations regarding the implications of the Subcommittee staff’s findings for tax law and policy changes.

With the Chairman’s permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

**Background: Deferral and Transfer Pricing**

**Deferral**

Under current U.S. rules, a U.S. multinational is not taxed on active foreign income earned through a controlled foreign corporation (including, generally, a greater than 50% foreign subsidiary) until the earnings are distributed as a dividend. 4 This is commonly referred to as deferral. A residual U.S. tax is paid on the dividend5 unless the credits for foreign income taxes paid with respect to the distributed earnings, as well as excess foreign taxes paid in respect of other foreign income of the U.S. parent in the same foreign tax credit limitation category, are sufficient to offset the U.S. tax on the dividend.6 Interest expense and other deductions of a U.S. multinational allocated to foreign income under foreign tax credit limitation rules are allowed as a current deduction, even if the foreign income is deferred from current U.S. tax. Through various devices, including gaps in our anti-deferral provisions, U.S. multinationals are able to reduce overall foreign taxes to burdens substantially below their effective U.S. tax rates. The combination of deferral of U.S. tax on earnings earned and reinvested at low foreign tax rates and current deductions for expenses contributing to earning deferred income is a powerful incentive to shift income offshore.

4 I.R.C. §§61(a)(7). Technically, a controlled foreign corporation is a foreign corporation that is more than 50% owned by vote or value, directly or indirectly by attribution, by United States shareholders, in turn defined for this purpose as a United States person that owns 10% or more by voting power, directly or indirectly by attribution. Earnings of a controlled foreign corporation may be deemed included in income under certain anti-deferral rules discussed later in my testimony. See I.R.C. §§951 - 964.

5 The current highest corporate tax rate is 35% for net income over $10 million. I.R.C. §11(b). The recapture of lower-bracket rates results in the corporate marginal rate to exceed 35% over limited income ranges.

6 See I.R.C. §§901, 902, 904. The foreign tax credit is subject to a limitation that the credit for foreign income tax may not exceed the pre-credit U.S. tax that would otherwise be paid by the taxpayer on foreign source net income in the same limitation category as the foreign tax. Today, there are only two foreign tax credit limitation categories, one for passive income and another “general” category that includes all non-passive income. U.S. multinational taxpayers that earn high-tax foreign income, or that through planning “bunch” foreign taxes into high-tax pools of earnings used to repatriate foreign taxes for use as credits, may use excess foreign tax credits against other low-taxed foreign income. For example, excess foreign tax credits can be used to offset U.S. tax on royalty income and income from sales that pass title to customers outside the United States that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by another country). See J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003), 31 TAX NOTES INT’L 1145 (2003).
Under the Internal Revenue Code’s anti-deferral rules, a United States shareholder in a controlled foreign corporation’s passive income, including interest, dividends, rents, royalties and capital gains not earned in an active business. In addition to limiting deferral for passive income, otherwise active business income earned through use of “base companies” that is subject to an effective rate of foreign tax that is lower than 90% of the U.S. corporate tax rate, may be currently included in a United States shareholder’s income. The two principal categories of active income that are subject to the anti-deferral rules are foreign base company sales income and foreign base company services income. The theory behind these provisions was that use of a base company in a low-tax jurisdiction is an indicator of tax avoidance that should preclude the benefit of deferral. These provisions do not apply, however, to income earned in the country of organization of the corporation or to income from sales of property manufactured by the corporation.

With the advent of U.S. “check-the-box” entity classification rules and the acceptance of contract manufacturing by a separate party as manufacturing for purposes of the exception from current taxation, it is reasonably easy to avoid the reach of the current taxation rules for most intercompany income. Statistics of Income data for 2006 show that approximately 80% of controlled foreign corporation earnings are retained and deferred from U.S. taxation, roughly 8% are distributed as dividends and 12% are currently taxed under Subpart F (recognize that Subpart F inclusions often are intentional in order to bring back earnings without triggering foreign withholding taxes). The average effective rate of foreign tax on foreign earnings of controlled foreign corporations with positive foreign earnings was approximately 16.4%.

Subpart F is in Subchapter N of Chapter 1 of the Code. A controlled foreign corporation is a foreign corporation that is more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by United States shareholders. I.R.C. § 957(b). A United States shareholder is a U.S. person that owns ten percent or more by vote, directly or indirect under constructive ownership rules, of the foreign corporation. I.R.C. § 951(b). Passive income defined as “foreign personal holding income” in Code section 954(c) is taxed currently. Current taxation of income from reinvesting deferred earnings to earn low-taxed income

I.R.C. §§ 954(d) and 954(b)(4).

I.R.C. §§ 954(d) and (e).

2006 IRS Statistic of Income (SOI) data show that 12.2% of foreign earnings and profits of controlled foreign corporations (with positive current year earnings) were taxed currently under Subpart F. Statistics of Income, Table 3. U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, and Subpart F Income, by Selected Country of Incorporation and Industrial Sector of Controlled Foreign Corporation, Tax Year 2006, at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html. An additional 7.9% of foreign earnings were distributed in a taxable distribution. Lee Mahony and Randy Miller, Controlled Foreign Corporations, 2006, STATISTICS OF INCOME BULLETIN 197, 202 Figure C (Winter 2011) (taxable payout ratio of 9.7% in relation to positive current year earnings and profits net of Subpart F income) see http://www.irs.gov/pub/irs-soi/11coforeign06winbull.pdf. When the 9.7% is measured in relation to positive current year earnings it is 7.2% (9.7% multiplied times the ratio of positive current year earnings and profits net of Subpart F income/current year earnings and profits 400,854,698/491,235,961 = 7.9%).

The United States deferral system includes rules that restrict a controlled foreign corporation from making its offshore earnings available to its affiliated U.S. group other than through a taxable dividend distribution. The Section 956 “investment in U.S. property” rules, adopted in 1962 and frequently adjusted since, treat a controlled foreign corporation’s offshore earnings that are invested in a broad range of U.S. investments, including a loan to its U.S. affiliates, as though the earnings were distributed as a dividend to a U.S. affiliate. The investment in U.S. property rules include significant exceptions that are designed to allow investment of offshore earnings in U.S. portfolio securities. The investment in U.S. property rules defend the residual U.S. tax on distributions but do not block holdings of U.S. portfolio investments.

The effect of the investment in U.S. property rules, when they work properly, is to protect the U.S. income tax base by preventing a U.S. multinational from using earnings not taxed by the United States in its U.S. business. These rules also restrict the advantage a U.S. multinational would have competing against a domestic U.S. business that will not have available low-taxed offshore earnings for use in its business. If there is leakage in the investment in U.S. property rules allowing deferred earnings to be loaned to the U.S. multinational’s U.S. business without U.S. tax, the benefit of deferral on the earnings loaned would be preserved so financing from pre-U.S. tax earnings (after a foreign tax) would be available to the U.S. multinational but not its

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12 I.R.C. § 956. The rules were strengthened in the 1970s after a U.S. shipping magnate circumvented this restriction by using his controlled foreign corporation shares as collateral for a loan. Ludwig v. Comm’r, 68 T.C. 979 (1977), nonacq., 1978-2 C.B. 1. In response, regulations were amended with addition of a rule known to all U.S. multinational financing lawyers (and auditors) – a pledge of stock will be deemed to be an investment in U.S. property by the controlled foreign corporation if “at least 66 2/3rds percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation’s discretion with respect to the disposition of assets or the incurrence of liabilities other than in the ordinary course of business.” Treas. Reg. §1.956-2(c)(2) (T.D. 7712, 1980). See Gustafson, Peroni & Pugh, TAXATION OF INTERNATIONAL TRANSACTIONS ¶6200-6220 (4th Ed. 2011).

13 I.R.C. §956(c).


15 Similar competitive concerns are raised by foreign parent multinational companies. They are addressed under other rules but tax advantages accruing to non-U.S. multinationals carrying on business in the United States demand equal scrutiny.
domestic competitors. The purpose of these rules is to prevent this, except in isolated cases of short-term loans.

**Transfer Pricing**

Transfer pricing generally refers to the prices one business charges another business under common control for intercompany transactions, including sales or leases of tangible property, the performance of services and transfers by sale or license of intangible property rights. The transfer pricing rules of Section 482 attempt to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. The rules attempt to place a controlled taxpayer on tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.

The transfer pricing rules necessarily are an imprecise tool. The rules allow a taxpayer to fully comply by selecting the most advantageous price that falls within a range of allowable alternatives. The difficulties with administering transfer pricing rules in relation to a sophisticated multinational group are compounded where comparable third-party transactions are unavailable or inexact, as in the case of most intangible property, and by the flexibility afforded a multinational corporate group in planning and executing its global legal and pricing structure to minimize tax. The problems are exacerbated by the taxpayer’s control over information and procedural advantages.

A multinational has the ability to shift income between two countries involved in transaction by structuring transactions to achieve that outcome. In 2010, the Treasury described increased tax-induced shifting offshore of U.S. corporate income documented in studies. The key conclusion of that review of studies based on aggregate data was that there was evidence of substantial income shifting through transfer pricing. The Subcommittee staff’s investigation of Microsoft provides support for the Treasury’s 2010 conclusions based on aggregate data. In both cases, the issue is tax-induced income shifting to zero or low-taxed jurisdictions, including countries that purport to tax but allow income allocations or special deductions to achieve a low effective tax rate.

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16 The benefit of deferral is not eliminated when the deferred earnings are reinvested in investments producing Subpart F income even when there is no U.S. interest deduction for the group. See generally, Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward Maydew, Terry Shevlin, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH*, 347-348 (4th Ed. 2009).  
17 I.R.C. §482; Treas. Reg. §1.482-1(a).  
18 Treas. Reg. §1.482-1(e).  
The Subcommittee Staff’s Case Studies: What Do They Tell Us?

Transfer Pricing

The Microsoft information provides additional visibility into the way one company organizes its affairs to shift very substantial amounts of income into low tax jurisdictions. The data that has been developed by the Subcommittee staff supplements what is publicly available, but does not include all the information that would be necessary to make an evaluation of whether the transfer pricing Microsoft employs would be justified under existing transfer pricing regulations.

I will not repeat the description of Microsoft’s business, organizational structure and international operations set out in the Subcommittee staff’s Memorandum, but I will summarize salient data from partial consolidating financial information provided to the Subcommittee staff in relation to companies in Ireland, Singapore and Puerto Rico. Because of limitations on the information provided, the findings must be considered preliminary and it is the scale rather than specific amounts that is most noteworthy.

Microsoft is a remarkable and a remarkably successful company. It is one company, however, and other companies will use other techniques to shift income. Microsoft’s income shifting strategies, including transfers of valuable intellectual property rights, are not unusual as evidenced in the 2010 case studies developed by the staff of the Joint Committee on Taxation. The Microsoft companies in Ireland with respect to which information was provided (including companies organized in Ireland but tax resident in Bermuda) included a cost sharing participant under a cost sharing agreement with Microsoft for rights to sell products in Europe the Middle East and Africa (“EMEA”) and companies that sell and ship copies of the Microsoft products in the EMEA. The same is true for the Singapore except they sell to the Asian region. The Puerto Rican company does the same for sales to the United States and other countries in North and South America.

In FY 2011, Microsoft had global revenues of $69.9 billion and earnings before tax of $28 billion. Microsoft’s global book tax rate was 17.5%. Microsoft had approximately 90,000 employees worldwide in 2011. Based on consolidating financials (without eliminations within those groups), in FY 2011 the Irish, Singapore and Puerto Rican companies earned approximately $15.4 billion in earnings before tax (EBT), or approximately 55% of global EBT. The average effective book foreign tax rate for the Irish, Singapore and Puerto Rican companies was approximately 4%. The break down by region was as follows:

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21 See, Staff of Joint Committee on Taxation, Present Law And Background Related To Possible Income Shifting And Transfer Pricing, (JCX 37-10 2010).
22 I refer to Microsoft’s fiscal year ending in June, 2011 instead of the most recently ended June, 2012 fiscal year because separate subsidiary information only was made available to the Subcommittee staff for FY 2011. The Microsoft corporation numbers are from Form 10-K for FY 2011.
Ireland, Singapore and PR FY 2011 ($ millions)

<table>
<thead>
<tr>
<th></th>
<th>Ireland</th>
<th>Singapore</th>
<th>Puerto Rico</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBT</td>
<td>$8,908</td>
<td>$2,485</td>
<td>$4,015</td>
<td>$15,407</td>
</tr>
<tr>
<td>Non-US taxes</td>
<td>$507</td>
<td>$69</td>
<td>$41</td>
<td>$617</td>
</tr>
<tr>
<td>ETR</td>
<td>5.69%</td>
<td>2.78%</td>
<td>1.03%</td>
<td>4.01%</td>
</tr>
</tbody>
</table>

This data illustrates in broad but concrete terms what has been shown in aggregate data, namely, that U.S. multinational companies aggressively locate earnings in low-tax locations. Indeed, to give one measure of the scale involved, the companies in these low-tax jurisdictions employed only 1,914 of Microsoft’s 90,000 employees, yet they earned $15.4 billion in earnings before tax or over $8 million per employee (compared to an approximate average of $311,900 for all Microsoft employees).

We do not have sufficiently granular information to form a view whether these results are consistent with existing transfer pricing regulations. Whether they are or are not, these results are not consistent with a common sense understanding of where the locus of Microsoft’s economic activity, carried out by its 90,000 employees, is occurring. The tax motivation of the income location is evident.

The objective of the arm’s length principle in transfer pricing is to achieve neutral treatment of related party and unrelated party transactions. The ability of multinational businesses to take advantage of transfer pricing between related persons in different countries strongly favors structuring transactions with affiliates to be able to shift income into low-taxed jurisdictions. It is an advantage that is largely unavailable to purely domestic businesses including most all small business enterprises. Yet, small businesses and individuals must make up the lost taxes.

Income shifting to tax-favored jurisdictions is the Macondo Well of the international tax system, except it is not a sudden catastrophe and the blow-out is not under control. Indeed, the gusher is not visible to the public or to most policymakers. It recently has been targeted by a small group of NGOs, mostly based in Europe. But the damage is real. Inadequate tax revenue has contributed to cut backs in vital government services in developed countries; the harm is worse in developing countries where scarce revenues are allocated among dire needs.
In this country, the Internal Revenue Service is taking strong steps to remedy what has been a long period of inadequate enforcement. In particular, Michael Danilack, Deputy Commissioner (International) in the Large Business & International division of the IRS, and Sam Maruca, IRS Director of Transfer Pricing Operations, and their colleagues, have undertaken important structural changes to improve enforcement. But income shifting to low-taxed jurisdictions only can be partially addressed by increased enforcement. We also must address core issues in the way the arm’s length standard has been permitted to be applied under existing U.S. regulations and the OECD’s transfer pricing guidelines. The arm’s length standard often has been interpreted or applied mechanically giving rise to results that do not pass a common sense reality test.

Transfer pricing also is affected by tax system design. Deferral, and even more, exemption of foreign profits, creates an irresistible incentive to move income to where it will be low-taxed or not taxed. This was understood when the Subpart F limits on deferral were first adopted – they were intended to serve as a vital backstop against transfer pricing abuse by reducing the incentives that could arise if income could be shifted to low-tax base countries. As noted above, those rules have been substantially eroded over time, most significantly by ill-conceived application of “check-the-box” disregarded entity rules in the international area, and furthered by Congressional actions restricting a response to this problem and adding additional exceptions that undermine the overall structure of Subpart F. Proposals to strengthen Subpart F by the Administration move in the right direction and, if materially strengthened, anti-base erosion proposals by Chairman Camp and Senator Enzi could materially improve the present situation (without going to an exemption system).

The incentive for multinational businesses to shift income abroad is increased and therefore income shifting is further encouraged when they are able to use deferred earnings for investment in the United States. That brings us to the findings in the HP case study.

Use of Deferred Earnings in the U.S. Business

The investment in U.S. property rules are a firewall. They are intended to allow the benefit of deferral to continue when deferred earnings are invested in a multinational’s non-U.S. business or in portfolio investments awaiting redeployment abroad. But they are intended to protect against a U.S. multinational benefitting from deferral in its foreign businesses and then using the pre-U.S. tax earnings in its domestic business against domestic competitors.23

The HP case study describes a series of pre-arranged steps between commonly controlled companies that appear to be intended to circumvent the limits crafted to provide flexibility for a

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23 The underlying policy is analogous to requiring a tax exempt entity that is engaging in a business to be taxed on its unrelated business income. In each case, the tax exemption cannot be used to advantage over a domestic competitor business.
controlled foreign corporation to make short-term loans to U.S. affiliates.\textsuperscript{24} For example, the Subcommittee staff finds that in FY 2010 HP had borrowed, primarily from two controlled foreign corporations (BCC and CCHC), between $6 billion and $9 billion throughout the first three quarters of the year. It is unclear whether the underlying sources of these loans were affiliates that have earnings and profits; however, it appears that HP may be relying in part on the loans being from separate controlled foreign corporations to sustain its position that it does not have a taxable income inclusion. I do not have sufficient information to reach a conclusion regarding HP’s particular situation. Courts regularly have used substance over form principles to take account of the pre-arranged and concerted actions such as those described, but this should not be left to audits and case law development over periods of years.

Whether or not the particular transactions pass muster under current law, the purposes of the investment in U.S. property rules are being circumvented. At a minimum, additional investigation would seem warranted. More directly, it should be made clear that techniques such as staggered loans and other subterfuges to use the fruits of deferred earnings in the U.S. parent’s U.S. business will not work. A variety of approaches to accomplish should be within the authority of the Treasury under current law. In addition to Section 956, Section 7701(l) was designed to give Treasury authority to combat these kinds of abuses without a need for new legislation. After repeated attempts to circumvent Section 956, it is time to adopt a broader anti-abuse rule by regulation.

The broader issue relates to the central role that the investment in U.S. property rules play in the U.S. system of deferral. If they are readily circumvented, then the premise that deferral only benefits international business is wrong and the multinational is advantaged by the ability to use profits shifted outside of the U.S. tax system in an affiliate’s U.S. business.

Conclusion

The Subcommittee is to be applauded for exposing practices that do not show up on public financial statements because of the elimination of intercompany transactions in consolidated financial statements.\textsuperscript{25} The Microsoft case study adds strong support to the findings

\textsuperscript{24} One exception allows a loan to be made over a measuring date so long as it is collected within 30 days and the controlled foreign corporation does not hold such obligations for more than 60 days during the year. Notice 88-108, 1988-2 C.B. 445. To provide relief during the 2008 liquidity crisis, Notice 2008-91 extended the period for short-term obligations to 60 days provided the controlled foreign corporation does not hold obligations that would be an investment in U.S. property for more than 180 days in the calendar year. This more generous rule was extended twice but in no event to a year beginning after 2010. Notice 2008-91, 2008-43 I.R.B. 1001; Notice 2009-10, 2009-5 I.R.B. 419; 2010-12, 2010-4 I.R.B. 326. Jacobs Engineering Group v. U.S., 97-1 USTC ¶50,340 (C.D. Cal. 1997); aff’d 99-1 USTC ¶50,335 (9th Cir. 1999), and Rev. Rul. 89-73, 1989-1 C.B. 258 both apply step transaction and substance over form doctrines to find an investment in U.S. property when a series of loans or loan rollovers around testing dates are employed to circumvent the rules.

\textsuperscript{25} To date, companies do not routinely disclose consolidating financial statements of the separate legal entities of the consolidated group. Consolidating financial statements, which are unaudited separate company statements, are routinely prepared in connection with preparing an audited consolidated financial statement. These consolidating
reported by Treasury in 2010 testimony and in the report on transfer pricing by the staff of the Joint Committee on Taxation. The study further buttresses the conclusion that there is substantial shifting of profits offshore by U.S. multinationals.

Because the study involves a single company, it would be very valuable to expend the study to include other companies. This should not hold up continued work by the IRS to improve its enforcement efforts, to develop procedural approaches that would reduce incentives for aggressive transfer pricing on tax returns and to re-examine the application of the arm’s length principle to instances of tax motivated location of profits that is de-coupled from the reality of where business is carried on.

The transfer pricing issues I have discussed become increasingly important under an exemption system. Until there is evidence that the gusher of profit shifting through transfer pricing has been capped in some way, it is risky, even foolhardy to consider shifting to an exemption system and inviting additional businesses to the income shifting trough. Instead, it would make sense to first adopt one or more of the anti-base erosion proposals that have been proposed in different contexts by both parties and evidence that the U.S. tax base is adequately protected.

Similarly, with respect to investment in U.S. property rules, additional investigation is warranted to determine the scope of use of the techniques described in the HP case study. The IRS should, as it has repeatedly in this area, adopt guidance that would permit grouping of related controlled foreign corporations for purposes of testing whether earnings are invested directly or indirectly in the United States as part of a broader anti-abuse rule.

Thank you and I would be pleased to answer any questions.