Written Testimony of Mark J. Mazur, Assistant Secretary for Tax Policy, U.S. Department of the Treasury
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Hearing on "The Shifting of Profits Offshore by U.S. Multinational Corporations"
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Chairman Levin, Ranking Member McCain, and members of the Subcommittee, I appreciate the opportunity to testify on the issue of the potential shifting of profits offshore and between foreign countries by U.S. multinational corporations.

This is a multifaceted, complex subject that raises numerous tax policy issues as well as issues relating to tax administration and tax accounting. My testimony, however, will be limited to tax policy considerations.

Potential Shifting of Profits Offshore by U.S. Multinational Corporations

The geographic allocation of profits earned by multinational enterprises historically has been challenging and has become more difficult with the rise of globalization. To see the complexity, consider a stylized example:

- Employees at a U.S.-based firm come up with an idea for a new software application;
- They collaborate with a team of software engineers at a subsidiary in Country A to elaborate on the concept and develop the initial prototype;
- Employees at a subsidiary in Country B develop and test the Beta version and pilot it to a limited audience;
- Employees at a subsidiary in Country C modify the Beta version for commercial use;
- Software is distributed in the U.S., Europe, and Asia through company-owned cloud computing centers; while
- Employees at a subsidiary in Country D oversee all the contractual arrangements between the parties and also account for all the transactions between related and unrelated parties.

The question that arises is where the income from this product is earned. Presumably, some sliver of income should be attributed to each of the subsidiaries, but because all the steps were required to successfully market the product, the appropriate geographic allocation between the U.S. parent and each of the subsidiaries is not obvious.

However, the Internal Revenue Code ("Code") requires that income be allocated to the various subsidiaries based on the "arm's length" standard, which is essentially what unrelated parties would charge each other for the goods or services provided. But, when parties are related and where there is not a well-defined market, it may be problematic to determine the arm's length prices that should prevail on these transactions. And with more cross-border transactions taking place between related parties, this issue has become bigger over the last few decades. It is important to realize that this is not just a U.S. problem. Virtually every country with a corporate income tax faces the challenge of determining what share of a global enterprise's income is part of that country's tax base. Pushing in the other direction are trends in tax planning and accounting where multinational enterprises are creating what some commentators have called "stateless income," not subject to tax in the jurisdictions where the company is located and where it does business.[1]

[1] *See, e.g.*, Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547 (Feb. 5, 2007).

Multinational corporations are able under current law to shift profits offshore and between subsidiaries located in different countries using various organizational structures and transactions. In some cases, a U.S. company transfers rights to intangible property to an offshore affiliate. Such cross-border transfers of intangible property rights could occur in various contexts, including cost-sharing arrangements. Under a cost-sharing agreement, a U.S. multinational corporation enters into an agreement with one of its controlled foreign corporations ("CFCs"), typically in a low-tax jurisdiction, in which both companies agree to share the costs and benefits of the development of intangible property. The CFC is required to pay the U.S. parent an arm's length amount for any existing intangible property or other resources it makes available for use in the shared research and development activities. Thereafter, the CFC contributes a percentage of the costs corresponding to its anticipated benefits from the intangible property to be developed (e.g., from the rights to exploit the intangible property in the CFC's territory). Under established transfer pricing principles, because the CFC bears its share of development costs, the CFC is entitled to the returns from exploiting the intangible property in its territory, which, in some instances, may be significant. This may be the case even if the CFC employs few people and otherwise performs few functions beyond the cost contribution and acting as owner of the intangible property.

In theory, the upfront arm's length payment for the intangible property originally contributed by the parent (reflecting the value of the property transferred), combined with the reduction in the parent's U.S. tax deductions, should result in no anticipated risk-adjusted loss of tax revenue to the U.S. as compared to the case in which no cost-sharing agreement is entered into. However, there has been considerable controversy about whether this result is achieved in fact.

Further, some other U.S. tax rules (e.g., the "check-the-box" rules and the Subpart F CFC look-through rule) allow U.S.-based multinationals to redeploy profits earned by the CFC from exploiting the intangible property to related CFCs (or other customers/licensees) without incurring a U.S. level of income tax. Under U.S. tax rules, the profits of foreign corporations are not subject to U.S. income tax until the profits are repatriated to U.S. persons, unless the profits constitute Subpart F income (discussed below). The postponement of taxation until repatriation is commonly referred to as deferral.

In other transactions, profits of foreign subsidiaries may be shifted by assigning certain risks to a minimal-activity foreign affiliate in a lower-tax jurisdiction. Such an affiliate may be treated as a "principal" earning profit (in the form of a risk premium) with respect to ongoing activities that continue to be conducted by the "de-risked" transferor.

Additional ways that U.S. multinationals may shift profits include moving intangible property (and related profits) offshore through various transactions that may not result in recognized income for U.S. tax purposes. In general, transfers of intangible property by a U.S. person to a non-U.S. corporation would result in a deemed royalty to the U.S. transferor under Code Section 367(d) over the useful life of the property that is commensurate with the transferee's income from the property. However, taxpayers sometimes take the position that this outcome does not apply to certain intangibles (such as workforce in place). In addition, taxpayers sometimes take the position that a disproportionate amount of intangible value represents foreign goodwill and going concern value (i.e., the value of a corporation to potential buyers as a continuing operation), which are explicitly carved out of the Section 367(d) regulations. Similarly, taxpayers sometimes take the position that foreign goodwill, going concern value, and workforce in place are not covered by the current definition of intangible property in the Code, so that their transfer is not subject to the arm's length transfer pricing rules of Code Section 482.

Changes in U.S. Corporate Income Tax Rates

Changes in U.S. corporate income rates – both in absolute terms and relative to the rates of our major trading partners – have changed the economic incentive for the shifting of profits. Before 1987, the U.S. maximum statutory corporate income tax rate was relatively high (between 46 percent and 53 percent from the 1950s through 1986) and roughly similar to those of other industrialized countries. The 1986 Tax Reform Act reduced U.S. income tax rates and broadened tax bases significantly and the maximum statutory corporate rate has remained at 34 percent or 35 percent since. Through the late 1990s, the U.S. corporate tax rate tended to be below the average for developed countries but since then, due to reductions in foreign corporate income tax rates, it has been above average and is now among the highest in the developed world.

A higher statutory rate can encourage companies to shift income and production to a lower-tax jurisdiction, especially in today's global marketplace. The immediate financial gain from shifting a dollar of income from one jurisdiction to another equals the difference in statutory income tax rates between the two locations. And while there may be costs to managing operations and earnings that have been shifted between jurisdictions, the multinational firm may still be better off from having done so. In addition, the statutory corporate income tax rate may also affect the decision to invest in one country rather than another, especially where the investments are independent and highly profitable.

Accounting Treatment of Deferred Earnings

U.S. multinationals are concerned not just about the tax treatment of their earnings but also about the financial accounting treatment. There is a presumption under U.S. Generally Accepted Accounting Principles (GAAP) that deferred income taxes should be recognized in the financial statements for the same period in which the earnings are generated because U.S. GAAP presumes that the foreign earnings will be remitted to the U.S.-based parent company at some point in time in order to distribute the earnings to shareholders. This presumption may be overcome if the firm develops sufficient evidence that the foreign entity has permanently invested or will permanently invest the earnings in the foreign jurisdiction. Accordingly, the deferral of earnings offshore not only offers a tax benefit (lower effective tax rate paid in the current accounting period) but may result in higher earnings for financial statement purposes (by presuming that the U.S. corporate income tax will never be paid on these "permanently" reinvested earnings). Thus, financial income reporting rules may add to the incentive to shift earnings.

Revenue Loss from Profit Shifting

Estimates of the potential revenue loss to the U.S. government from profit shifting cover a wide range, from $10 - $20 billion to well over $80 billion per year. These estimates attempt to consider profit shifting from all sources, including non-arm's length transfer pricing on intercompany trade with affiliates, strategic location of debt, and transfers and location decisions involving intangibles. One prominent estimate showed a revenue loss to the Federal government of $87 billion for 2002. This estimate included shifting by both U.S.-based multinationals and foreign-based multinationals operating in the United States.[2] Other estimates are lower, for example, one indicated a revenue loss of $17.4

[2] Clausing, Kimberly A., "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, Vol LXII, No. 4, December 2009, pp. 703-724. This estimate attributes the difference in profitability between U.S. multinational firms and their affiliates abroad to differences in the U.S. and host country tax rates and allocates the profit difference to the United States based on the share of affiliate transactions that occur with the United States relative to the share that occurs with affiliates in other countries. This approach does not take into account the myriad other factors that may affect differences in profitability.

billion for U.S.-based companies in 2004, though this only attempted to measure the additional shifting that occurred in 2004 relative to that which occurred in 1999 and not total shifting.[3]

Author	Annual Tax Shift	Year of Estimate
Clausing (2009)	$87 b	2002
Christian and Shultz (2005)	$30 b	2001
Sullivan (2008)	$17.4 b	2004

A different way to develop estimates of the magnitude of profit shifting involves estimating the potential revenue gain from adopting specific policies intended to restrict income-shifting opportunities. In this regard, the Joint Committee of Taxation estimated that the revenue gain from completely repealing deferral would be around $11 billion in 2010.

One study of sales-based formulary apportionment approaches to allocating income to geographic locales estimates that its adoption would have raised $50 billion in 2004.[4] However, that estimate does not incorporate all the behavioral responses by companies if formulary apportionment were implemented. A different analysis that attempts to simulate various behavioral responses concludes that formulary apportionment would raise no more revenue than the current system.[5]

All these estimates are necessarily based on a set of assumptions about behavior and profitability. For example, some studies assume that rates of return or profit margins in the United States and foreign locations would be the same if there were no income shifting. Others try to estimate statistical relationships between profitability in a country and tax differentials. And most of these studies are based on financial data published by the Commerce Department, not tax data. That said, these studies provide some insight into the potential magnitudes of profit shifting and the effect on Federal revenues.

Overview and History of the Subpart F Rules

The Subpart F rules attempt to prevent the shifting of income, either from the United States or from the foreign country in which it was earned, into a low- or no-tax jurisdiction. Thus, Subpart F generally targets both passive and mobile income. The Subpart F rules discourage the shifting of these types of income by disallowing deferral of U.S. taxation for such income and requiring current taxation. (In related party transactions, the shifting of income may be achieved more easily because a commonly controlled group of corporations can direct the flow of income between entities in different jurisdictions.)

The Subpart F rules are set forth in Code Sections 951-964 and apply to certain income of CFCs. The Code defines a CFC as a foreign corporation more than 50 percent of which, by vote or value, is owned by U.S. persons, each of whom owns a 10 percent or greater interest in the corporation by vote (each a "U.S. shareholder"). The term "U.S. persons" includes U.S. citizens or residents, domestic corporations, domestic partnerships, and domestic trusts and estates. If a CFC has Subpart F income, each U.S. shareholder must include its pro-rata share of that income in its gross income as a deemed dividend in the year the income was earned. Thus, this income is taxed at the U.S. tax rate in the year earned (that is, the tax on this income is not "deferred").

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[3] Sullivan, Martin A., "U.S. Multinationals Shifting Profits Out of the United States, *Tax Notes*, March 10, 2008, pp. 1078-1082.
[4] Clausing, Kimberly A. and Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Brookings Institution: The Hamilton Project, Discussion paper 2007-2008, June 2007.
[5] Altshuler, Rosanne and Harry Grubert, "Formula Apportionment: Is it Better Than the Current System and Are There Better Alternatives," *National Tax Journal*, forthcoming.

Subpart F was enacted in 1962 during the Kennedy Administration. Key rationales for its enactment included preventing tax abuse, taxing passive income currently, promoting equity, promoting economic efficiency, and avoiding undue harm to the competitiveness of U.S. multinationals. While the Kennedy Administration proposal would have ended deferral for all income earned by foreign subsidiaries of U.S. taxpayers, Congress was concerned that ending deferral completely would place U.S. companies at a competitive disadvantage in their foreign operations. The enactment of Subpart F was a more modest step toward ending deferral, focused on the types of income that were viewed as more easily shifted.

The Subpart F rules have been modified since 1962. For example, in 1976, a new foreign base company shipping income category was added.[6] In 1982, a new category of foreign oil-related income was added. In 1986, many changes were made to the Subpart F rules, including the expansion of the foreign personal holding company income category to include income from commodities (unless derived in the active conduct of a qualifying commodities business), gains from the disposition of many types of property and certain foreign currency gains. In 1997, the foreign personal holding company income category was expanded to include income from notional principal contracts and substitute dividend payments. Additionally, a temporary exception for income derived from the active conduct of a banking, financing or insurance business was added after being removed 11 years earlier (and this exception has been extended multiple times, most recently in the American Taxpayer Relief Act of 2012). A look-through rule providing an exception to foreign personal holding company income for payment of dividends, interest, rents and royalties out of active earnings was added in 2006.[7]

Subpart F may, in some cases, not be doing what it was intended to do. It is possible for taxpayers to avoid some important provisions of Subpart F, due in part to the proliferation of hybrid entities and hybrid instruments. Hybrid entities are entities that are classified as flow-through entities in one jurisdiction (for example, the United States) and as corporations in another jurisdiction. Hybrid instruments are financial instruments that are treated as debt in one jurisdiction and as equity in another jurisdiction. Therefore, it is now possible in some cases to shift income to low- or no-tax jurisdictions and earn passive income in such jurisdictions without triggering Subpart F and having this income taxed in the U.S. as it is earned.

The Check-the-Box Rules

Several observers have noted that the proliferation of techniques involving hybrid entities has lessened the effectiveness of the current Subpart F regime. Although not the exclusive source of these planning techniques, the "check-the-box" entity classification regulations, which became effective January 1, 1997, have resulted in significantly increased use of hybrid entities. And while initially not aimed at foreign affiliates, these rules have been substantially used by multinational firms.

The availability of tax avoidance techniques involving hybrid entities did not originate with the check-the-box regulations. However, the check-the-box regulations exacerbated the problem in three significant ways. First, they eliminated the uncertainty associated with applying the existing test for entity classification. This reduced the costs and risks associated with hybrid arrangements and thus greatly facilitated their use. Second, they focused attention on the use of hybrid arrangements. The result was a considerable increase in design and marketing efforts among tax planners that introduced hybrid planning techniques to mainstream taxpayers. Finally, and perhaps most importantly, the check-the-box regulations facilitated the formation of a new type of entity (or non-entity): an entity "disregarded as an entity separate from its owner" (often referred to as a "disregarded entity"). The disregarded entity features prominently in a number of Subpart F tax planning techniques.

[6] The foreign base company shipping income category was repealed in 2004.
[7] For more information about the development of the Subpart F rules, see Treasury's Policy Study: "The Deferral of Income Earned through U.S. Controlled Foreign Corporations" (December 2000).

The Administration is concerned about the misuse of various income-shifting devices, including misuse of the check-the-box rules, to inappropriately avoid the Subpart F rules, and thus has proposed legislative changes to tighten rules and reduce incentives that encourage the shifting of investment and income overseas.

Section 954(c)(6) Look-through Rule

Congress enacted the so-called "look-through rules" under Section 954(c)(6) as part of the Tax Increase Prevention and Reconciliation Act of 2005. Section 954(c)(6) allows one CFC to make payments of dividends, interest, rents, and/or royalties to a related CFC without resulting in Subpart F income to the recipient CFC so long as the amounts are attributable to income of the payor CFC that is neither non-Subpart F income nor income effectively connected with the conduct of a U.S. trade or business. Section 954(c)(6) was intended to allow U.S. multinational corporations to redeploy their active foreign earnings without incurring a level of U.S. tax.

Section 954(c)(6) was enacted as a temporary provision effective for taxable years beginning after December 31, 2005, and before January 1, 2009. Since then, Section 954(c)(6) has been extended three times (most recently in the American Taxpayer Relief Act of 2012) and is currently in effect through taxable years beginning before January 1, 2014.

Impact of the Check-the-Box Rules and Section 954(c)(6)

The check-the-box rules and Section 954(c)(6) both result in a higher amount of earnings being eligible for deferral. Deferral encourages U.S. multinationals to keep earnings offshore.

The Treasury Department estimates that the U.S. revenue impact of these provisions is on the order of a few billion dollars per year, mainly because the provisions reduce the after-tax cost of foreign activity and therefore encourage such activity. The provisions also reduce repatriation of profits to the parent company, albeit with a higher U.S. residual tax rate for the funds that are repatriated. Absent these provisions, the shifting of profits from high- to low-tax foreign countries would occur less frequently and would incur greater costs. The United States generally would not directly receive significant additional revenue as a result of the profits not being shifted, but U.S. multinationals would pay higher foreign taxes through their foreign subsidiaries (and thus to the extent these earnings were repatriated, there would be a lower residual U.S. tax, after foreign tax credits).

Administration Initiatives to Reduce the Shifting of Profits Offshore

The President's Framework for Business Tax Reform is intended to strengthen the international tax system. The proposals for reform take a multi-pronged approach that reduces incentives for companies to shift profits and investment to low-tax countries, puts the United States on a more level playing field with our international competitors, and helps slow (or perhaps end) the global race to the bottom on corporate tax rates. There is considerable debate as to how to reform the international tax system, but there appears to be common ground on this subject, including a shared concern about preserving the U.S. tax base by reducing incentives for the shifting of investment and income overseas and about making the United States a more attractive place to create and retain high-quality jobs.

The President's Framework would impose a minimum rate of tax on the income earned by the foreign subsidiaries of U.S. multinationals. This would discourage companies from moving profits offshore. Foreign income otherwise subject to deferral in a low-tax jurisdiction would be subject to immediate taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on the income paid to the host jurisdiction. This minimum tax would be designed to provide a balance by limiting the opportunities to shift profits to lower-tax jurisdictions while also placing U.S. multinationals on a more level playing field with local competitors.

The President's Framework for Business Tax Reform also would incorporate many of the international tax proposals included in the President's FY 2014 Budget that would discourage U.S. multinationals from shifting profits (and specifically profits related to intangible property) offshore. Under one such proposal, a new category of Subpart F income would be added for excess profit returns from intangibles that have been transferred by a U.S. person to a related CFC. Specifically, this proposal provides that if a person transfers intangible property from the U.S. to a related foreign affiliate that is subject to a low foreign effective tax rate in circumstances evidencing excess income shifting, then the U.S. person must include in income currently the amount equal to the excessive return.

A second proposal would clarify the scope of intangible property that is subject to the deemed-royalty rules of Section 367(d) and the transfer pricing rules of Section 482 to include workforce in place, goodwill and going concern value. Another proposal addresses the concern that, under current law, a U.S. business can borrow money and invest overseas and take a current deduction for the interest related to overseas investment, even though the U.S. business may pay little or no U.S. taxes on the income from the overseas investment. The Administration's proposal would eliminate this tax advantage by requiring that the deduction for interest expense attributable to the overseas investment be matched with the income it is supporting (that is the deduction for interest expense would be delayed until the related income is taxed in the U.S.).

Furthermore, the Treasury Department and the Internal Revenue Service (IRS) have issued regulations and other guidance to discourage the shifting of profits offshore. In 2008, the Treasury Department and the IRS issued comprehensive temporary regulations under Section 482 pertaining to cost-sharing arrangements. These temporary regulations, which became effective on January 5, 2009, and were finalized in 2011, clarified a number of contentious issues and better defined the scope of intangible property transfers and contributions that require compensation. Early anecdotal information indicates that the regulations have had a positive impact on taxpayers' reporting positions. As an important complement to the cost sharing regulations, in 2009, the Treasury Department and the IRS also finalized regulations covering service transactions, including services performed using high value intangibles.

Additionally, the Treasury Department and the IRS have recently issued regulations under Section 909 that limit the use of foreign tax credits in situations in which foreign taxes are inappropriately separated from (and taken into account in advance of) the underlying foreign income with respect to which the foreign taxes were paid. The regulations defer the ability to claim a foreign tax credit for foreign taxes until the related income is taxed in the United States. The Treasury Department and the IRS have also issued regulations under Section 367(a)(5) that make it more difficult to move earnings offshore in tax-free reorganization transactions, and Notice 2012-39 reduced incentives to move intangible property offshore as part of a tax-free repatriation strategy.

Finally, the Treasury Department supports the efforts of the Organisation for Economic Co-Operation and Development (OECD) to analyze these profit-shifting issues and is actively participating in the OECD's projects to address these issues, including the project analyzing Base Erosion and Profit Shifting. This important multilateral effort is evidence that governments around the world are wrestling with these difficult issues and trying to find ways to address inappropriate profit-shifting.

Thank you, and I look forward to answering your questions.