AVI-YONAH TESTIMONY FOR HEARING ON PROFIT SHIFTING
US SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
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My name is Reuven S. Avi-Yonah. I am the Irwin I. Cohn Professor of Law and Director of the International Tax Master of Law Program at the University of Michigan Law School. I hold a JD (magna cum laude) from Harvard Law School and a PhD in History from Harvard University. I have over twenty years of full and part time experience in the tax area, and have been associated with or consultant to leading law firms like Wachtell, Lipton, Rosen & Katz, Cravath, Swaine & Moore and Cadwalader, Wickersham & Taft. I have also served as consultant to the US Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair of the AALS Tax Section, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published eleven books and over 100 articles on various aspects of US domestic and international taxation, and have eighteen years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

I would like to thank Senators Levin and Coburn and the Committee staff for inviting me to testify today on the shifting of profits offshore by U.S. multinational corporations,

1. Introduction

In 1991, a federal judge made the following statement about the application of IRC section 482 to the Puerto Rican affiliate of a US pharmaceutical:

For tax years 1972 through 1976, MSDQ reported taxable income that totals $181,802,000. Federal income tax paid was $657,000. The pricing process that produces such disparity between costs of production and end-product prices, and permits the accumulation of retained earnings that amount to 98.82 percent of all reported taxable income, may be economically unjustified or socially unacceptable… Such problems cannot be addressed through Section 482, under the statute and regulations as presently written.[1]

This case was one of a series of cases in which US multinationals transferred ownership of intangibles to tax haven affiliates and successfully claimed that any profits related to the intangibles should not be currently taxed by the United States because they "belong" to where the intangible was located.[2]

[1] Merck v. United States, 24 Cl.Ct. 73, 91 (1991).
[2] For a review of those cases see Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Virginia Tax Rev. 89 (1995), updated version in 9 Finance and Tax L. Rev. 310 (2006).

These results were in fact considered "economically unjustified or socially unacceptable." Congress responded in 1986 by revising IRC section 482 for the only time in its long history, adding the requirement that whenever an intangible is transferred to an offshore affiliate, whether by way of sale, license, or contribution to capital, a royalty must be paid that is "commensurate with the income" generated by the intangible. The general understanding of this "super-royalty" rule was that it required gradually increasing the royalty to bring all the profits from the intangible back onshore.

The results of this Subcommittee's investigation show that we are now back where we were before 1986. As a result of a series of Treasury and IRS mistakes, the Congressional intent behind the 1986 amendment to section 482 has been completely undermined. U.S. multinationals are once again able to concentrate almost all their profits from intangibles developed in the U.S. in select offshore jurisdictions with very low effective tax rates. In my opinion, this suggests that the time has come for Congress to once again revise the statutory language to close the loopholes that make these results possible. Specifically, Congress should (a) override "cost sharing," which is the regulatory regime that undermines the super-royalty rule, and (b) repeal IRC 954(c)(6) and the application of "check the box" to costlessly shift profits from one offshore jurisdiction to another, since it is that shift that makes the transfer of profits out of the U.S. so appealing.

2. The Transfer of Intangibles and Cost Sharing

The Subcommittee's investigation reveals a consistent pattern of tax planning among U.S. Multinationals. These multinationals develop intangibles in the United States but are able to shift the profits from the intangibles to low-tax jurisdictions offshore by using cost sharing arrangements. The data assembled by the Subcommittee show that there is no correlation between the location of these profits and the actual activities undertaken by the multinationals in locations like Ireland, Singapore or Puerto Rico.

For example, consider the following Subcommittee data for Microsoft. In 2011, Microsoft earned $8.93 billion in Ireland, and paid an effective Irish tax rate of 5.76%. It had 1,050 employees in Ireland, so this translated to over $8 million per employee. In Singapore, Microsoft earned $2.48 billion at an effective tax rate of 2.74%, with its 687 employees each contributing over $3 million. Most impressively, in Puerto Rico Microsoft earned $4.015 billion (mostly for sales to the U.S.), paid taxes at an effective rate of 1.02%, and its 177 employees each supposedly generated over $22 million in income.[3]

How are these outcomes possible? They are the direct result of cost-sharing.

[3] Of course, the employees in those locations do not actually add that much value, and their low salaries are commensurate with what they contribute and not with the earnings booked in the three low-tax jurisdictions.

Cost-sharing is a regime introduced by Treasury and the IRS in the early 1990s. Under cost-sharing, the U.S. parent enters into an agreement with a controlled foreign corporation (CFC) to share the costs of developing an intangible. Importantly, nothing actually happens in the CFC: The entire development takes place in the U.S.. The CFC contributes a portion of the costs (e.g., 80%), which it can do by simply receiving a contribution from its parent and paying it back. If the development is successful, the CFC is then entitled to 80% of the profits from the intangible, without any concern in regard to the potential application of IRC 482 and the regulations thereunder (including the super-royalty rule).

The idea behind cost-sharing was that the multinational cannot know whether the development will be successful, and that it risks losing 80% of the R&D deduction if it is unsuccessful because this deduction is shifted to the CFC, which does not have U.S. source income. This, it was thought, would inhibit the multinationals from taking too aggressive a position in their cost-sharing agreements.

But this idea is deeply flawed, for two reasons. First, successful intangibles result in profits that far outweigh the costs of development. Thus, it makes sense for a multinational that develops an intangible for $100 million with a profit potential of $1 billion to risk losing $80 million in deductions, if there is a good chance that this will shield $800 million or more in profits from current U.S. taxation. The data assembled in this investigation, like the $15 billion earned by Microsoft in 2011 in Ireland, Singapore and Puerto Rico, shows the immense sums that can be earned from the successful exploitation of intangibles.

Second, for cost-sharing to work the multinational cannot know whether the intangible will be successful or not. But multinationals are in the best position to know precisely that, and it is very hard for the IRS to second-guess their knowledge or lack thereof. Multinationals typically enter into cost-sharing agreements only when they know the intangible will be profitable, and while in theory this requires a "buy-in" payment by the CFC that leads to results similar to the super-royalty rule, in practice this becomes a valuation issue and the IRS has not been successful in litigation over buy-in payments.[4]

In a September 12, 2012 letter to Senator Levin, Deputy Commissioner (International) Michael Danilack has summarized the results of cost sharing for 15 U.S. companies (9 in IT and 6 others). All of the 28 cost sharing agreements summarized were with low tax jurisdictions. The data show that the return on assets in these jurisdictions under the agreements was 268% (363% for the IT companies), as compared with 40% return on assets in the US. Commissioner Danilack explained that such higher foreign returns may be due to "enhanced profitability of foreign operations" or "a significant and unexpected upturn in the market value of the transferred intangible asset after the transfer." These are

[4] See, e.g., Veritas, 133 TC 14 (2009). In addition, a significant element of the actual costs may be excluded from the scope of the cost sharing agreement, which can dramatically limit the potential downside for the taxpayer. See Xilinx, 598 F3d 1191 (9th Cir., 2010). The IRS has adopted new regulations that seek to reverse the result in *Veritas*, but I am doubtful the outcome will be different because of the fundamental flaws identified above.

precisely the kind of outcomes that Congress intended the super-royalty rule to prevent, because the rule forces the CFC to increase the royalty rate if the intangible turns out to be more profitable. The data indicate that even with buy-in payments cost-sharing cannot achieve results consistent with IRC section 482 as modified in 1986.

Thus, in my opinion the data assembled by the Subcommittee investigation show that cost-sharing has been an expensive mistake. It enables multinationals to shift the profits from intangibles developed in the U.S. offshore without incurring any serious risk of losing the R&D deductions.

3. Subpart F, Check the Box and the CFC Look-Through Rule

Cost-sharing by itself would not have been as problematic for the U.S. fisc but for another mistake made by the Treasury in 1997, when it adopted the "check the box" rule and applied it to foreign entities. The result has been the elimination of Subpart F for payments that shift profits from one CFC to another, resulting in the ability to concentrate all offshore profits in a few low-tax jurisdictions. As the Subcommittee data show, a disproportionate percentage of the profits of the multinationals the Subcommittee investigated are located in very few countries where these multinationals have no other indicia of value added (such as employees, assets or sales).

Under "check the box", U.S. multinationals can choose to treat foreign corporations as disregarded entities for U.S. tax purposes, even though they are treated as corporations for foreign tax purposes. The result is that deductible payments (for foreign tax purposes) from those entities to other CFCs are disregarded for Subpart F purposes and do not give rise to Subpart F income. Treasury realized that this was a mistake as early as 1998, but was precluded from rectifying it by pressure from Congress and taxpayers. In 2006, Congress wrote the result into law by enacting IRC 954(c)(6), which provides that payments from one CFC to another are disregarded regardless of "check the box", but this is a temporary provision that expires periodically, so that multinationals still rely on "check the box" to avoid Subpart F inclusions for such payments.

The Subcommittee data reveal that the standard tax planning technique for U.S. multinationals seeking to transfer their profits offshore is to have a few top level CFCs to which the intangibles get transferred via cost-sharing, and that are treated as a corporation under "check the box." All the other entities below these intangible holding corporations are treated as disregarded entities under "check the box," and as a result, deductible royalties (for foreign tax purposes) paid from entities in high-tax jurisdiction to the holding companies are ignored for Subpart F purposes. In addition, there are no "thin capitalization" rules for royalties (i.e., they are fully deductible with no limitations, unlike interest) and they are typically not subject to withholding tax under treaties that follow the OECD model. As the Subcommittee data show, the result is that most of the offshore profits of the multinationals are concentrated in a few low-tax jurisdictions.

It has been argued since 1998 that shifting profits from one foreign jurisdiction to another only harms foreign Treasuries and benefits U.S. multinationals. In my opinion, the

Subcommittee data show that this view is mistaken, because it is the ability to shift profits from high to low tax jurisdictions is key to the shifting of profits out of the U.S.. If the profits had been subject to a foreign tax rate that is significantly higher than zero, there would have been much less incentive to shift the profits out of the U.S. (especially if, as both the Administration and Congressional Republicans have proposed, the U.S. corporate tax rate is reduced to a level commensurate with the OECD average).

4. The Erosion of the U.S. Corporate Tax Base

The Subcommittee's data indicate one reason for the recent erosion of the U.S. corporate tax base, which has been documented in other studies as well. The 2011 report by CTJ and ITEP examined the 280 most profitable U.S. corporations and found that the average effective federal income tax rate for this group was 18.5% in 2008-2010 and 17.3% in 2009-2010. In other words, 280 of the Fortune 500 companies were paying tax at half the 35% statutory rate. Some 78 of these companies paid no federal income tax between 2008 and 2010.

The ability of corporations to reduce their corporate tax payments by shifting profits offshore in the ways documented by the Subcommittee investigation leads both to an erosion of the corporate tax base, which reduces overall revenues, and to significant disparities among corporate taxpayers. The profit shifting techniques described above only work effectively for taxpayers whose profits depend primarily on valuable intangibles. Other taxpayers, including domestic enterprises multinationals whose profits are more linked to bricks and mortar operations, report much higher effective tax rates.

Deferral is now the biggest tax expenditure, and $1.7 trillion of profits are "trapped" overseas in low-tax jurisdictions because they cannot be brought back onshore because they will incur 35% tax on dividends. As a result, to prevent a deferred tax accounting charge, multinationals must declare that these earnings are permanently invested overseas.[5]

There are a variety of proposed solutions to this situation, ranging from abolishing deferral to adopting some kind of territorial tax system. But there is a broad agreement that whatever solution is adopted must address the profit shifting described above. Not doing so risks further eroding the U.S. tax base at a time when revenues are sorely needed.

5. Conclusion and Recommendations

The situation described in the Subcommittee report represents a complete reversal of what Congress intended when it adopted the super-royalty rule in 1986. Once again, U.S.

[5] See J.P. Morgan, Global Tax Rate Makers, May 16, 2012, available at www.morganmarkets.com. Of course, the earnings are not truly trapped, both because the taxpayers can always bring them back if they are willing to pay the deferred tax, and because taxpayers are continually coming up with new ways to repatriate earnings without incurring tax.

multinationals are able to shift most of their profits from intangibles developed in the U.S. to a select group of low-tax offshore locations.

A complete solution to the profit- shifting opportunities in the current regime is not possible without thorough reform of the international tax system. In the short run, however, it is advisable to address the specific loopholes that underlie the current situation. I would therefore recommend restoring the efficacy of the super-royalty rule by (a) adding a proviso to IRC section 482 that the rule will apply notwithstanding any cost-sharing agreement entered into after the date of enactment; (b) repealing IRC 954(c)(6) and requiring Treasury to adopt the regulations it proposed under IRC 954 to limit the application of check the box in ways that undermine Subpart F.