WRITTEN TESTIMONY
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HEARING ON
THE SHIFTING OF PROFITS OFFSHORE BY U.S. MULTINATIONAL CORPORATIONS
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INTRODUCTION

Chairman Levin, Ranking Member McCain, and members of the Subcommittee, thank you for the opportunity to testify on tax compliance and administration issues related to the shifting of profits offshore by U.S. multinational corporations.

The IRS takes very seriously the need to ensure that U.S. multinational corporations are abiding by U.S. tax laws and paying their fair share of tax. Over the last few years, we have been working to enhance our approach to international tax enforcement in general and to offshore profit shifting in particular. We have been refocusing our enforcement efforts to be more strategic by viewing taxpayers through the prism of their tax planning strategies and allocating our limited resources to cases presenting the highest compliance risk.

In implementing this new approach, we began from the premise that we need to determine where companies are using legitimate strategies to manage global tax exposure and where they may be pushing the envelope too far. Thus, we have been aligning our resources and training our employees in key strategic areas such as income shifting, deferral planning, foreign tax credit management, and accessing profits accumulated offshore through repatriation transactions.

To better manage our collective knowledge in strategic international compliance areas, we have formed 18 International Practice Networks, which are focused on integrating our training and data management with our strategy. We have also established a new International Practice Service, which will serve as a central repository for the knowledge and expertise of our international staff. For example, in the income shifting area, an international practice network is in the process of developing 25 different training and job aid tools, and over 400 international staff members have been participating in regular network calls devoted to income shifting topics.

As the IRS works to address tax avoidance issues involving multinationals, it is also important that we continue to work with other countries. At the multilateral level, the IRS and the Treasury Department are active participants in the Organisation for Economic Co-Operation and Development, where we are currently participating in several major guidance projects. The goal is to develop a coordinated and comprehensive action plan to update international tax rules to reflect modern business practices while preventing inappropriate cross-border profit-shifting.

CURRENT ISSUES IN TAXATION OF U.S. MULTINATIONALS

The IRS' enforcement authority in regard to profit shifting by U.S. multinational corporations arises primarily from section 482 of the Internal Revenue Code, under which the IRS is charged with ensuring that taxpayers report the results of transactions between related parties as if those transactions had occurred between unrelated parties. Under the section 482 regulations, as well as under multinational transfer pricing guidelines, the determination of whether the pricing of a transaction reflects an arm's length result is generally evaluated under the so-called "comparability standard." Under this standard, the results of the transaction as reported by the taxpayer are compared to results that would occur between by unrelated taxpayers in comparable transactions under comparable circumstances.

Establishing an appropriate arm's length price by reference to comparable transactions is relatively straightforward for the vast majority of cross-border transactions involving transfers of goods or services. But enforcing the arm's length standard becomes much more difficult in situations in which a U.S. company shifts to an offshore affiliate the rights to intangible property that is at the very heart of its business – what may be referred to as the company's "core intangibles." In fact, over the past decade, applying section 482 in these types of cases has been the IRS' most significant international enforcement challenge.

When the rights to the core intangibles of a business are shifted offshore, enforcement of the arm's length standard is challenging for two reasons:

- First, transfers of a company's core intangibles outside of a corporate group rarely occur in the market, so comparable transactions are difficult, if not impossible, to find. In some cases the IRS has had to resort to other valuation methods, which are often referred to as "income-based methods." Under these types of methods, the IRS typically has to conduct an *ex ante* discounted cash flow analysis. This means that we are required to evaluate the projections of anticipated cash flows that the taxpayer used in setting its intercompany price; then we must further evaluate how the taxpayer discounted those projected cash flows to compensate for the risk associated with earning them. The challenge here is that evaluating the underlying assumptions made by the taxpayer, without benefit of hindsight, is not an exact science.

- Second, a business's core intangible property rights are by their nature very "risky" assets. So projecting cash flows from these assets and the appropriate

> discount rate requires an inherently challenging assessment of the underlying risk and how, and by which party, that risk is borne. These can be difficult assessments to make, at least in some cases.

Outbound international tax planning involves not only shifting profits to low-tax jurisdictions, but also managing exposure to the Code's anti-deferral provisions under subpart F. Subpart F requires U.S. shareholders of controlled foreign corporations (CFCs) to include currently in income for U.S. tax purposes their pro rata share of certain of the CFC's income – including dividends, interest, rents, royalties, and income from certain sales and services transactions. However, because subpart F contains many exceptions, careful planning allows companies to avoid subpart F inclusions and even to enhance income shifting to low-tax jurisdictions.

Commonly, a company's strategy involves the making of deductible payments from foreign affiliates operating in high-tax jurisdictions to affiliates organized in low-tax jurisdictions. For example, if a low-tax affiliate lends to a high-tax affiliate, the interest expense related to that loan offsets the higher taxes imposed on the affiliate paying the interest, and the interest income received by the recipient affiliate is subject to a low, or zero, rate of tax. Under the original framework of the subpart F regime, the interest or royalty income received by the low-tax affiliate would constitute subpart F income and therefore would be taxable to the U.S. parent of the multinational group. Taxpayers, however, have long been able currently to avoid subpart F through various techniques.

For example, avoidance of subpart F on foreign-to-foreign deductible payments was facilitated with the issuance of the check-the-box regulations in 1997. Under these regulations, an eligible business entity can elect its classification for federal tax purposes. Of particular note, the check-the-box regulations provide that an eligible foreign entity with a single owner can be treated as "disregarded" as a separate entity and therefore taxed as a branch for U.S. purposes. As a result, deductible payments – such as interest and royalties – paid between the disregarded entity and its owner (or between two disregarded entities with the same owner) are ignored for U.S. tax purposes and avoid subpart F treatment. Importantly, these payments continue to be regarded for foreign tax purposes and thus reduce taxable income in the high-tax foreign jurisdiction.

Today, taxpayers can also rely on the so-called "CFC look-through rule" under section 954(c)(6) to avoid subpart F treatment on deductible payments without resorting to the check-the-box regulations. This rule excludes from subpart F income dividends, interest, rents, and royalties paid by one foreign affiliate to another affiliate, to the extent the payment is out of non-subpart F earnings of the payor.

Once profit is shifted to a low-tax foreign affiliate, and subpart F is avoided, U.S. multinationals will seek to repatriate offshore cash to the United States with minimal tax consequences. Simply dividending the cash to a U.S. affiliate will result in U.S. taxation at a 35-percent rate, reduced by a credit for any foreign tax imposed on the earnings. So U.S. multinationals seek ways to repatriate cash through sophisticated structures they assert do not result in dividend treatment. This is another area in which we are dedicating enforcement resources to ensure that these transactions are treated appropriately.

IRS ACTIONS TO IMPROVE TAX COMPLIANCE BY MULTINATIONALS

Transfer Pricing

The IRS' approach to the income shifting challenge is evolving. In the early 2000s, the IRS formed teams of experts known as issue management teams, or IMTs, to focus on transfer pricing and related business practices. These teams were made up of IRS transfer pricing specialists and Chief Counsel attorneys, led by IRS industry executives, and centrally managed the "inventory" of examinations involving transactions in these respective areas. The teams ensured that IRS resources were appropriately dedicated to these examinations, that best practices and processes were shared, and that the IRS position on the underlying issues was applied uniformly to cases under similar facts and circumstances.

In 2011, a new IRS executive position was created to oversee all transfer pricing-related functions, to set an overall strategy in the area, and to coordinate work on our most important cases. Further, in building a new function devoted exclusively to tackling our transfer pricing challenges, we recruited dozens of transfer pricing experts and economists with substantial private sector experience to help us stay on the cutting edge of enforcement and issue resolution.

Transfer Pricing Operations is divided into two parts. First is the Transfer Pricing Practice, which collaborates with other international personnel and industry groups to identify strategic work in the transfer pricing area and ensure appropriate development and presentation of cases with strategic merit. Second is the Advanced Pricing and Mutual Agreement program (APMA), which was created a year ago through the merger of our Mutual Agreement and Advanced Pricing Agreement programs. These new functions operate as a unified team with a global focus, a unified strategy, and a robust knowledge base.

Cost Sharing

The IRS has worked with the Treasury Department over the last several years to adopt revised regulations on cost sharing. In 2008, new section 482 regulations pertaining to cost sharing transactions were issued. These temporary regulations were effective on January 5, 2009, and were finalized in 2011. They clarify a number of issues that had been contentious under the previous set of cost sharing regulations and better define the scope of intangible property contributions that are subject to taxation in connection with cross-border business restructurings. While to date the IRS has had limited experience in auditing transactions covered by the new cost sharing regulations, early anecdotal information indicates that the regulations have had a positive impact on taxpayers' reporting positions in the area.

However, concerns remain that we are considering and following closely. Some taxpayers are taking the position that a cost sharing arrangement, or other transaction taxable under section 482, has been preceded, either explicitly or implicitly, by an incorporation or reorganization transfer of core intangibles. In these cases, the taxpayers assert, among other positions, that foreign goodwill and going concern value are the most valuable elements in these transfers. In response, we are now training our agents to address these issues and to challenge taxpayers' positions where appropriate.

Repatriation of Earnings

Focusing on the repatriation area, Treasury and the IRS over the past six years have issued several anti-abuse notices – one as recently as July 2012 – making clear that a variety of transaction types give rise to inappropriate repatriation results. In several of these cases, Treasury and the IRS have already followed up with regulatory changes necessary to make clear what the appropriate results should be.

In general, these transactions were designed to take advantage of mechanical rules which are scattered through the Code and regulations, and which pertain to determinations of either tax basis or earnings and profits. These rules were not written with repatriation in mind, and the transactions in which the rules have been used may not look like repatriation transactions at first blush – so they can be difficult to find. But we are finding them and where we have, we have acted quickly.

As to specific repatriation strategies being challenged by the IRS, these often involve foreign affiliates entering into various transactions with their U.S. parent that result in the parent receiving cash, notes or other property from the affiliates. Taxpayers assert that these transactions do not result in a dividend or gain to the U.S. parent corporation under various corporate non-recognition provisions. Examples of these transactions include so-called "Killer B" transactions, "Deadly D" transactions, zero-basis structures, and outbound F reorganizations. While these types of transactions have been addressed by new regulations, for pre-effective date periods the IRS has challenged many of them under common law doctrines and will continue to do so.

Taxpayers have also attempted to avoid dividend treatment by manipulating the amount and timing of a foreign subsidiary's earnings and profits. The IRS has challenged these types of transactions under existing law and has had some success. For example, in *Falkoff v .Commissioner*, the Seventh Circuit Court of Appeals reversed a Tax Court holding that a corporation's distribution in advance of recognizing earnings had economic substance.

Moreover, taxpayers may be able to offset residual U.S. tax on foreign earnings by using foreign tax credits. For example, taxpayers have implemented so-called "splitter" transactions to free up foreign tax credits for use to offset U.S. tax on repatriated low-taxed earnings. The IRS has challenged such transactions, under both the applicable provisions of the Code and underlying regulations and various judicial doctrines. Further, legislation enacted in 2010, *i.e.*, section 909, and the regulations published thereunder in 2012, should put a stop to many of these transactions.

Foreign corporations also enter into various repatriation transactions that are disguised loans to their U.S. parent corporation. Taxpayers assert that these transactions are not subject to section 956 and therefore do not result in income inclusion to the U.S. parent. The IRS has challenged, and will continue to challenge, these types of transactions under the applicable provisions of the Code and regulations, and under various judicial doctrines such as the doctrine of substance over form. For example, in *Merck & Co. Inc.* the Third Circuit Court of Appeals held that interest rate swaps entered into with foreign subsidiaries constituted a disguised loan subject to section 956.

Further, to address abusive short-term loan transactions like the one highlighted by this Subcommittee in the past, we developed and delivered specialized training for our employees on these issues. In April 2013, we conducted a three-hour online training session focusing on section 956, which was attended by more than 250 international examiners. This training session, which remains available online to all international employees, covers the general anti-deferral rules under section 956, as well as the exception for short-term loans, avoidance planning techniques, and audit techniques. We are also developing detailed job aid tools related to the section 956 short-term loan exception and the techniques being used to exploit it.

Casework: Examinations and Litigation

The IRS has been, and continues to be, vigilant and forceful in addressing compliance issues we have seen in regard to U.S. multinationals. Based on a recent survey, as of May 9, 2013, we estimate that we are currently considering income shifting issues associated with approximately 250 taxpayers involving approximately $68 billion in potential adjustments to income.

As for litigation in the income shifting area, the IRS has challenged approximately 34 transfer pricing issues involving 15 taxpayers in 22 U.S. Tax Court cases over the past three years. Of those 22 cases, the IRS litigated and lost two: *Xilinx v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010), and *Veritas v. Commissioner*, 133 T.C. No. 14 (2009). In *Xilinx*, the IRS included stock-based compensation as a cost to be shared in a cost sharing arrangement. Unfortunately, the court did not sustain the government's position. In *Veritas*, the IRS challenged the taxpayer's buy-in amount under the cost-sharing arrangement by applying an income method. In this case as well, the court rejected the government's approach and sustained the taxpayer's buy-in amount with some adjustments.

CONCLUSION

Mr. Chairman, Ranking Member McCain, thank you again for this opportunity to testify on the IRS' efforts to enforce the tax law as it applies to U.S. multinational corporations. Although enforcing and administering this section of the tax law will present challenges for the IRS into the future, the agency has made great strides in recent years, and this is a tribute to strategic focus and to the highly dedicated and professional men and women of the IRS. I would be happy to answer any questions you have.