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Testimony of Stephen E. Shay
Before the
U.S. Senate Permanent Subcommittee on Investigations
Of the Committee on Homeland Security and Governmental Affairs
Hearing on Offshore Profit Shifting and the Internal Revenue Code

May 21, 2013

Chairman Levin, Ranking Member McCain 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.[1] I am a Professor of Practice at Harvard Law School.[2] The views I am expressing are my personal views.

The Subcommittee and its staff should be commended for pursuing this important investigation. Protecting the existing U.S. tax base is an important responsibility of those in Congress and the Administration responsible for the fiscal health of the country. The revenue lost to tax base erosion and profit shifting is hard to estimate, but there is compelling evidence the amount lost is substantial. This revenue loss exacerbates the deficit and undermines public confidence in the tax system. Restoring revenue lost to base erosion and profit shifting would support investing in job-creating growth in the short term and reducing the deficit over the long term.

My testimony provides background information on the taxation of foreign income of U.S. multinationals earned through a controlled foreign corporation and on transfer pricing.[3] The testimony next discusses the information developed by the Subcommittee Staff regarding Apple's international tax planning and considers how current elements of U.S. tax law contribute to key elements of that planning. I will make a limited number of observations regarding the implications of the Subcommittee's Apple case study for tax law changes and conclude.

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[1] My testimony is at the request of the Subcommittee, by letter dated May 1, 2013 from Chairman Carl Levin and Ranking Member John McCain. I am testifying in a personal capacity. My testimony 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 resigning in 2009 to serve in government. I occasionally consult for Ropes & Gray LLP on mutually agreed projects. I have provided a copy of my biography to the Subcommittee and a disclosure of my outside activities is posted on my faculty website page. Members of my family own Apple stock.

[3] The background portion of my testimony draws from my September 21, 2012, testimony before this Subcommittee. Readers familiar with these areas of law may wish to skip this background discussion.

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

Background: Taxation of Foreign Subsidiary and Income Transfer Pricing

Taxation of Foreign Subsidiary Income

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.

The United States allows a domestic corporation that owns 10% or more of the voting stock of a foreign corporation a credit for foreign income taxes paid with respect to earnings received as a dividend in respect of that stock. A U.S. shareholder also may offset U.S. tax on a foreign dividend with excess foreign taxes paid in respect of other foreign income in the same foreign tax credit limitation category.[5] Accordingly, there is a residual U.S. tax on foreign earnings distributed as a dividend unless allowable foreign tax credits are sufficient to offset the U.S. tax. Interest expense and other deductions of a U.S. multinational, allocated to foreign income for purposes of determining the foreign tax credit limitation, are allowed as a current deduction even if the foreign income is deferred from current U.S. tax.

Through various devices, including gaps in anti-deferral provisions, many 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 foreign earnings, where the tax saved is reinvested at low foreign tax rates, and current deductions for expenses contributing to earning deferred income is a powerful incentive to shift income offshore. This incentive is magnified by financial accounting rules that allow undistributed foreign earnings to be taken into account in consolidated income without reserving for future U.S. tax if the earnings are considered indefinitely reinvested abroad.

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[4] I.R.C. §§61(a)(7). The highest corporate tax rate is 35% for net income over $10 million. I.R.C. §11(b). The recapture of lower-bracket rates causes the corporate marginal rate to exceed 35% over limited income ranges. Earnings of a controlled foreign corporation may be deemed included in a United States shareholder's income under certain anti-deferral rules discussed below. See I.R.C. §§951 - 964.

[5] See I.R.C. §§901, 902, 904. The credit allowed for foreign income taxes is subject to a limitation, The credit for foreign income tax may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign source net income in the same limitation category as the foreign tax. Today, there generally are 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 in the same category. 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 Subpart F anti-deferral rules, a United States shareholder in a controlled foreign corporation is subject to current income inclusion of its share of the controlled foreign corporation's "foreign personal holding company income," including interest, dividends, rents, royalties and capital gains not earned in an active business.[6] In addition to limiting deferral for passive income, certain other sales and services income earned through use of "base companies" may be currently included in a United States shareholder's income.[7] 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.[8] A United States shareholder may elect not to include currently Subpart F income that is subject to an effective rate of foreign tax greater than 90% of the highest U.S. corporate tax rate. The theory behind these base company sales and services provisions was that use of a base company in a lower-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.[9]

With the advent of U.S. "check-the-box" entity classification rules in 1997 and more recently the expansive acceptance of contract manufacturing by a third party for purposes of the "manufacturing" exception from foreign base company sales income, it is reasonably easy to avoid the reach of the Subpart F anti-deferral rules for a broad range of 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% were distributed as dividends and 12% were currently taxed under Subpart F (and it should be recognized that Subpart F inclusions often are intentional in order to bring back earnings without triggering foreign withholding taxes).[10] For that year, the average effective rate of foreign tax on foreign earnings of controlled foreign corporations with positive foreign earnings was approximately 16.4%.[11]

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[6] 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 indirectly 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 one category of "foreign base company income" that is taxed currently.

[7] I.R.C. §§ 954(d) and 954(b)(4).

[8] I.R.C. §§ 954(d) and (e).

[9] Subpart F also has a de minimis exception if a controlled foreign corporation's foreign base company income is less than the lesser of 5% of gross income or $1 million and a "full inclusion" rule if more than 70% of a foreign corporation's gross income is foreign base company income. The discussion in the text is a summary of the relevant provisions and is not intended to be comprehensive. For example, the discussion does not cover, *inter alia*, the active foreign finance or insurance exceptions to Subpart F or foreign base company oil income.

[10] 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

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.[12] The investment in U.S. property rules include significant exceptions that are designed to allow investment of offshore earnings in U.S. portfolio securities.[13] 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.[14]

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.[15] These rules also restrict the advantage a U.S. multinational

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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/positive current year earnings and profits (400,854,698/491,235,961) = 7.9%).

[11] 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 and author's calculations. The average effective rate disguises far lower effective rates for certain industries and companies, such as Apple. Companies in the resource industries often pay much higher levels of foreign tax.

[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).

[14] Accordingly, it is commonplace for a controlled foreign corporation to hold U.S. dollar bank deposits, U.S. government and corporate debt securities of unrelated issuers, and U.S. equity securities of unrelated issuers. A 2011 survey by the U.S. Senate Permanent Investigations Subcommittee majority staff estimated that of $538 billion of undistributed accumulated foreign earnings (of 27 surveyed multinationals as of the end of FY 2010) approximately 46% was invested in U.S. bank accounts and securities. U.S. Senate Permanent Investigations Subcommittee Majority Staff, Report Addendum to *Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals* (Dec. 14, 2011).

[15] 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).

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 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 charged between affiliates 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.[16] 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.

From the first set of transfer pricing regulations in 1968, taxpayers have been permitted to share the costs of development of an intangible under a *bone fide* cost sharing arrangement as a means to determine which affiliates may earn returns attributable to the intangible. One of the substantial attractions for taxpayers of *bona fide* cost sharing is that the IRS generally will limit adjustments to the appropriate ratio for sharing costs. While the sharing ratio has been the subject of dispute, the far more substantial issue historically has been the valuation of contributions of pre-existing intangibles.[17]

If at the commencement of the cost sharing arrangement a participant possesses a resource, capability or right that is anticipated to contribute to development under the cost sharing arrangement, the other participants must compensate that participant for the fair market value of the contribution. The issue of pre-existing intangibles is referred to by practitioners as the "buy-in" problem, but the name is somewhat misleading. The "buy-in" concern is not limited to valuing intangible property that pre-exists the commencement of the cost sharing arrangement, but extends to the full range of contributions to development by affiliates whether or not they are participants in the arrangement. Paying for the full range and value of contributions has proved to be an Achilles heel (from the perspective of tax authorities) of cost sharing between related persons for tax purposes.

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[16] I.R.C. §482; Treas. Reg. §1.482-1(a).

[17] See Seagate Technology, Inc. v. Comm'r, 102 T.C. 149 (1994); Veritas Software corp. v. Comm'r 133 T.C. 297 (2009).

IRS and Treasury guidance regarding cost sharing has evolved through a series of developments reflecting successive problems with cost sharing in practice. The first limited guidance was given in final regulations in 1968. By the Tax Reform Act of 1986, it became clear that international transfer pricing was a substantial issue, particularly in relation to the territorial system adopted in Code Section 936 for Puerto Rico, so Section 482 was amended to permit a post-transfer review of the pricing of intangible property.[18] In 1988, the Treasury issued a White Paper on transfer pricing that sought to provide a sounder theoretical under pinning for the treatment of intangibles.[19] This was followed by 1992 proposed regulations that were heavily criticized by business and then 1995 final cost sharing regulations.

In 2007, the Treasury issued a report to Congress on transfer pricing that reported substantial evidence consistent with income shifting from non-arm's length pricing.[20] The 2007 Treasury Report acknowledged "that CSAs [cost sharing agreements] under the current regulations pose significant risk of income shifting from non-arm's length pricing." It reported on proposed regulations issued in 2005 that adopted a new "investor model" approach and that substantially expanded the newly-named "platform contributions" to the development of intangibles that should be compensated under new cost sharing arrangements. On the last day of 2008, the proposed regulations were largely adopted as temporary regulations, however, cost sharing agreements that were in existence on January 5, 2009 (and updated in certain respects), were subject to "grandfather" rules that insulated these agreements from the full force of the new rules. Final regulations were issued in 2011.[21]

The premise of the cost sharing rules is straightforward. If a participant shares all of the costs and all of the risks of developing a new intangible property, it is entitled like an entrepreneur to earn the returns from making that investment. As we were reminded in the global financial crisis of 2008, however, the application of theory and models in the messiness of the real world can lead to unintended or unanticipated results. As demonstrated by the repeated efforts to strengthen the cost sharing regulations and the continued evidence of income shifting to lower tax countries, the application of cost sharing in the context of the international taxation has proven to be highly problematic. This is in part because assumptions necessary for the theory of cost sharing to be valid, including that all contributions are fully accounted for, are nearly impossible to control in a real world setting.

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

[18] See I.R.C. §482 (second sentence).
[19] 1988-2 C.B. 458.
[20] U.S. Department of the Treasury, "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties," (Nov. 2007).
[21] T.D. 9568, 76 FR 80082 (Dec. 22, 2011).

alternatives or, in respect of intangibles, by entering into a cost sharing arrangement.[22] 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 is the case with respect to most high-value 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.[23]

<u>The Subcommittee Staff's Apple Case Study: What Does It Tell Us?</u>

The Apple information provided to the Subcommittee Staff offers visibility into the way one company organizes its affairs to shift very substantial amounts of income into low- or zero-tax jurisdictions. (Through its tax treatment of nonresident Irish corporations, Ireland may be considered both a low- and a zero-tax jurisdiction at the same time -- without explicitly providing a tax holiday.) The data developed by the Subcommittee staff supplements what is publicly available, but is limited to consolidating financial information (as opposed to tax return information) and written responses to Staff questions. Because of limitations on the information provided, and the circumstances under which it is made available,[24] the following discussion must be considered preliminary.

I take no position on the legal correctness or strength of any tax position taken by Apple. What are of interest are the techniques used to shift income to low-taxed countries and the scale of the income shifting that is possible.

Apple's business, organizational structure and international operations is described in the Staff Memorandum to the Subcommittee ("Staff Memorandum"). Apple is a remarkable and a remarkably successful company. In FY 2011, Apple had consolidated global revenues of $112 billion and earnings before tax of $34 billion.[25] Apple's FY 2011 global book tax rate was 24.2%, though Professor Harvey calculates it would be 12.8% if all of the Irish earnings are

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[22] Treas. Reg. §§1.482-1(e), 1.482-7.

[23] See J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Worse than Exemption*, 59 Emory LAW J. 79, 119-127 (2009).

[24] To preserve confidentiality, information only was made available at the Subcommittee offices or in the presence of a Subcommittee staff member. In the future, I suggest that the Subcommittee employ a secure virtual data site, which is customary practice in commercial merger, acquisition and financing transactions to preserve confidential company data.

[25] I refer to Apple's fiscal year ending September 24, 2011 instead of the most recently ended fiscal year because separate subsidiary information only was made available to the Subcommittee staff for FY 2011. The Apple consolidated numbers are from Apple's Form 10-K for FY 2011.

considered permanently reinvested.[26] Apple had approximately 59,000 employees worldwide in 2011.

Apple Transfer Pricing

The Apple companies in Ireland with respect to which information was provided (including companies organized in Ireland but reportedly tax resident nowhere) included two cost sharing participants under a longstanding cost sharing agreement with Apple for rights to sell products outside North America. In 2011, one of Apple's Irish cost sharing participants, Apple Sales International (ASI), contracted with third party manufacturers to make products and sold these products outside of North America.[27] Based on consolidating financials (without eliminations within those groups), in FY 2011 Apple's Irish companies earned approximately $22 billion in earnings before tax (EBT), or approximately 64% of global EBT. The Apple Irish companies' EBT to sales margin was 46% compared to 23% for Apple US.[28]

The effectiveness of Apple's transfer pricing and Irish nonresident company tax strategy is evident from the breakdown of Apple's FY 2011 EBT:

		FY2011		
	US	Ireland	ROW	Total
EBT ($ billions)	$10.2	$22.0	$2.0	$34
EBT share	30%	64%	6%	100%
Customers (approx.)	39%	1%	60%	100%

This illustrates in concrete terms for one company what has been shown in aggregate data, namely, that Apple aggressively shift earnings to a low- or zero-tax location.

To give a different measure, the Irish companies employed only 2,452 of Apple's 59,000 employees, yet they earned $22 billion in earnings before tax or over $9 *million* per employee. This actually is understated, since after the 2012 reorganization only 613 employees were assigned to the cost sharing companies (ASI and Apple Operations Europe). If 613 employees

[26] This seems a reasonable adjustment in light of Apple's decision to issue $17 billion in debt to help finance a $55 billion stock buyback rather than repatriate earnings and reportedly pay $9.2 billion in tax. Peter Burrows, Apple Avoids $9.2 Billion in Taxes With Debt Deal, Bloomberg.com (May 3, 2013), at http://www.bloomberg.com/news/2013-05-02/apple-avoids-9-2-billion-in-taxes-with-debt-deal.html?cmpid=yhoo (last visited May 19, 2013). See also, Martin Sullivan, "Economic Analysis: Apple Reports High Rate But Saves Billions On Taxes," 2012 TNT 29-2 (Feb. 9, 2012).

[27] In 2011, the distribution of personnel and functions among Irish companies was somewhat mixed up and was rationalized in 2012. See description in Staff Memorandum. For purposes of describing numbers of employees and earnings before tax (EBT), I will treat the entities as one entity.

[28] The better measure for transfer pricing analysis is operating income, however, I use EBT for comparability reasons. Use of operating income would not affect the findings.

was the correct count for 2011, the EBT/employee would be *$35.8 million per employee* compared to an approximate average of $576 thousand per employee for all Apple employees.

The average effective book foreign tax rate for the Irish companies was under 1%. Apple described its low Irish tax rate as follows: "Since the early 1990s, the Government of Ireland has calculated Apple's taxable income in a way to produce an effective rate in low single digits …since 2003 it has been 2% or less." According to Apple, the principal Irish companies in terms of income, Apple Operations Europe (AOE) and ASI, are not tax resident in Ireland. Based on Apple's disclosures so far, it is not clear that AOI, AOE and ASI are tax resident anywhere.

For U.S. tax purposes, Apple treated ASI and AOE as disregarded entities wholly-owned by Apple Operations International (AOI), an Irish-organized company with no employees or operations also considered by Apple to not be tax resident in Ireland. If the foregoing is correct, for U.S. tax purposes, all of the income earned by ASI and AOE is would be considered owned by AOI.

AOE and ASI, pay Irish tax only on their business carried on in Ireland. ASI is a party to the cost sharing agreement, but it is not clear where income attributable to the intangibles in which ASI has an interest is treated as earned; it appears to be allocated away from Ireland for Irish tax purposes, i.e., it could be what is fondly referred to by international tax planners as "ocean income." It would be difficult to achieve a less than 2% Irish effective tax rate if that income were subject to Irish tax at a 12.5% corporate tax rate (assuming it is considered trading income) or a 20% rate (if it is not).

The facts in this case raise the question whether the income that is shifted to Ireland is shifted from the United States or from the countries where the customers are located (the source or market countries). There is no doubt that some income is shifted from the market countries, but it is reasonably clear that the largest part of the value in Apple's products arises from its proprietary technology. Some is attributable to Apple's marketing, for which Apple U.S. makes a small charge to affiliates. It is doubtful that the preponderance of the Irish income is properly allocable to the in-country selling activity. In sum, for its non-U.S. sales Apple's use of cost sharing transfers the return to R&D performed in the United States to Ireland (or the ocean).

The tax motivation of Apple's income shifting is evident. The appropriate way to test the reality of the Apple arrangement is to ask whether Apple would have entered into this cost sharing arrangement if Apple's Irish affiliates had been unrelated. Over the three year period, 2009 – 2011 Apple's Irish cost sharing participants paid approximately $3.3 billion in cost sharing payments to Apple US. While that is a very large number, over the same period Apple's Irish affiliates earned EBT (after those payments) of $29.3 billion.[29] In other words, the $3.3

[29] As noted above, the better measure is operating income, but the numbers would remain enormous.

billion investment earned the right the substantial portion of $32.6 billion, or almost a 10 times return. The U.S. tax deferred likely is over $10 billion. The ability to reinvest those tax savings is a valuable tax benefit.

So, would Apple have entered into this cost sharing arrangement if Apple's Irish affiliates had been unrelated? To answer "yes" strains credulity.

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.

There does not appear to be meaningful information regarding the effect of recently finalized cost sharing regulations on cost sharing. Anecdotally, it appears that companies have sought to grandfather existing agreements, as Apple has done, and are looking for other strategies for new projects.[30] This will bear monitoring closely. Of one point there is assurance, taxpayers will continue to focus on transfer pricing so long as there is potential to take advantage of material income tax differentials.

There are many potential steps that may and should be taken to improve the law and administration in respect of transfer pricing. I will discuss one proposal that transcends transfer pricing and bears consideration by the Subcommittee. There is a substantial need for more transparency by large public and comparable private companies. To date, companies do not routinely disclose information from consolidating financial statements with respect to the material 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 statements should be made available on a company web site with respect to each material company (with eliminations) along with information regarding the tax residency of each material company. This would provide valuable information to investors and analysts, who could monitor the group's assets and profitability by company, and more approximately by jurisdiction, and better assess the company's country and tax risks. This increased transparency would improve the monitoring of

[30] It has been suggested that transferring existing intangible property in tax-free transactions so as to be subject to Section 367(d) rules avoids the reach of some of the rules of the cost sharing regulations. That certainly should not be correct in that Section 367(d) should not have a different outcome than Section 482.

multinational businesses by shareholders, civil society and tax authorities alike and put downward pressure on corporate agency costs.[31]

Deduction Dumping

The benefit of income shifting is enhanced when deductions are incurred in the United States to earn low tax foreign income that is deferred from U.S. tax. Borrowing a table from Professor Harvey, below, it appears that Apple's general and administrative and sales, marketing and distribution expenses are incurred disproportionately in the United States. This helps explain the lower ratio of U.S. EBT to U.S. sales.

Allowing a current deduction for whatever portion of these expenses is attributable to income booked in the Irish companies (instead of in the United States) effectively is a U.S. tax subsidy those deferred earnings. Allowing the expense as a deduction, unreduced by the foreign earnings to which it is attributable (applying existing U.S. allocation rules), provides a tax saving benefit equal to the difference between the U.S. and foreign rate and the ability to invest that saving until the foreign earnings are distributed.

	Pre-tax Income/Sales		% of Pre-tax Income	General & Administrative Expenses		Sales, Marketing, & Distribution Expenses	
				$ billions	%	$ billions	%
US	24%		30%	1.7	85%	3.3	59%
Non-US	36%		70%	0.3	15%	2.3	41%
Consolidated	32%		100%	2	100%	5.6	100%

The allocation of deductions issue is a large dollar issue not only for Apple, but for the U.S. tax system more generally. In FY 2008, deductions allocable to foreign income (but not allocable to specific types of income) on Forms 1118 totaled $201 billion, including $99 billion of interest, $78 billion of other deductions (such as overhead expense) and $23 billion of R&D. The portion of these deductions properly allocable to deferred earnings should not be allowed as deductions until the deferred income is repatriated to the United States. This issue would become even more significant if the United States were to shift to a dividend exemption for active foreign income.[32]

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[31] It should be possible to adopt standards that would address trade secret concerns. There is no public policy interest in basing market competition on transfer pricing and tax strategies.

[32] Proposals to use a 5% "haircut" in a possible U.S. dividend exemption system as a surrogate for allocating expenses materially understate the amount of deductions allocable to foreign income.

Sidestepping Anti-Deferral Rules

Deferral, and even more, exemption of foreign profits, creates an irresistible incentive to shift income to where it will be low-taxed or not taxed. This was understood when the Subpart F limits on deferral were first adopted in 1962 – 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- or zero-tax countries. Apple's international structure takes full advantage of loopholes in existing anti-deferral rules. These rules have been substantially eroded, most significantly by ill-conceived application of "check-the-box" disregarded entity regulations in the international area. This problem was exacerbated by Congressional actions restricting a response to the problem. Additional exceptions that undermine the overall structure of Subpart F include an unprincipled expansion of the manufacturing exception to foreign base company sales income to cover contract manufacturing, the Section 954(c)(6) look-through rule and a "same country exception" based on place of incorporation.

Apple avoids the reach of the foreign base company sales rules by contracting for manufacture of its products by third parties and in most cases, for U.S. tax purposes, selling to third parties. By using check-the-box disregarded entities, intercompany transactions within the group of companies that are classified as disregarded entities simply disappear.[33] With respect to payments of interest and dividends, the look-through rule of Section 954(c)(6) accomplishes much the same result except to the extent that deductible payments offset income of the payor that would be subject to current U.S. tax.

Finally, the same country exceptions for dividends and interest apply based on place of incorporation, whether or not the corporation is tax resident in the country of incorporation. Even before check-the-box and the look-through rule, taxpayers were taking advantage of nonresident Irish companies to sidestep this rule. If changes are made to check-the-box and look-through rules, changes also should be made to this same country exception. As a general proposition, if it is retained in anything like its present form, Subpart F should operate on a branch-by-branch basis and not by reference to place of incorporation.[34]

Implications of Apple Case Study - Where to Go From Here

Our international tax rules are out of balance. They are too generous to foreign income and not strong enough in protecting against U.S. base erosion by foreign companies investing in the United States. The losers are domestic business.

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[33] It remains necessary to consider the application of the foreign base company sales rules for sales and manufacturing branches, but they also are fairly readily controlled.

[34] See American Bar Association Tax Section Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 TAX LAW. 649, 787-809 (2006).

In the context of current law, changes may be made that would limit the scope for profit shifting. Most promising is a “minimum tax” imposed on the U.S. shareholder of a controlled foreign corporation in respect of low-tax foreign income earned by the controlled foreign corporation. In design, it actually would be a deemed distribution, as under current Subpart F, but the remaining U.S. tax would be collected when the earnings are distributed or the stock is sold. This approach would effectively take away the advantage of tax havens.

This should be accompanied by taking away the advantage of tax havens for foreign companies that invest in the United States. The United States should protect its source tax base by measures that may include imposing withholding tax on and/or restricting deductions for deductible payments of income paid to or treated as beneficially owned by related persons not “effectively taxed” on the income. In doing this, the United States would take away a substantial advantage that foreign-owned companies have in structuring investments in the United States.

Adopting a balanced approach is necessary to assure a level playing field. I have described elsewhere an approach that if taken by the United States would provide an incentive for other countries to adopt complementary rules. Moreover, the United States should strongly support and lead efforts at the OECD to combat base erosion and profit shifting. I acknowledge that the ideas described above need development into specific proposals, but this may be done in a reasonable time frame and will have value in relation to the principal international tax reform proposals.

Should Congress wait for tax reform to address income shifting? The short answer is “no.” The two tax writing committees have begun work on a fundamental revision of the tax code. Many options on specific issues have been floated and a number of actual proposals put in draft legislative language. Some are good and some are bad. Like Vladimir and Estragon asking what Godot looks like, however, the players in the tax reform effort do not know what tax reform looks like. Without a coherent direction to the effort, including agreement on basic objectives and consistency in revenue estimating, the undertaking will founder or result in a messy patchwork of unstable political compromises. The political difficulty of the undertaking requires leadership from the Administration (centered in the Treasury Department, not the White House) as well as from the Hill. The technical complexity of the undertaking requires utilizing the knowledge and economic analysis skills of the Treasury Office of Tax Policy as well as the Staff of the Joint Committee on Taxation. The work on tax reform is at very early stages and will take years. Do not be lulled into “waiting for tax reform.”

Conclusion

The Subcommittee is to be applauded for exposing international tax practices that are not easily discernible from public financial statements. The Apple case study adds further support to the findings from aggregate data that there is substantial shifting of profits offshore by

U.S. multinationals.[35] Apple's income shifting strategies, including its cost sharing 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 and in the testimony presented in hearings by the U.K. Public Accounts Committee.[36] I encourage the Subcommittee to pursue reforms in the short term to adequately protect the U.S. tax base.

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

[35] In 2010, Treasury testimony reviewed a range of studies that indicate substantial income shifting to lower tax countries, including evidence from company tax data of margin increases correlated inversely with effective tax rates. The key conclusion of that review of studies based on aggregate data was that there was evidence of substantial income shifting through transfer pricing. Testimony of Stephen E. Shay, Deputy Assistant Secretary International Tax Affairs, U.S. Department of Treasury, House Ways and Means Committee, Hearing on Transfer Pricing Issues (July 22, 2010), http://democrats.waysandmeans.house.gov/media/pdf/111/2010Jul22_Shay_Testimony.pdf.

[36] See, Staff of Joint Committee on Taxation, Present Law And Background Related To Possible Income Shifting And Transfer Pricing, (JCX 37-10 2010);House of Commons, Committee of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011–12, Nineteenth Report of Session 2012–13, ¶¶ 7- 12, Ev 21 – Ev 50 (HC 716, Dec. 3, 2012), at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf (last visited March 16, 2013) (Oral Evidence Taken from Troy Alstead, Starbucks Global Chief Financial Officer, Andrew Cecil, Director, Public Policy, Amazon, and Matt Brittin, Google Vice President for Sales and Operations, Northern and Central Europe, on Monday, November 12, 2012).