

The Offshore Shell Game: U.S. Corporate Tax Avoidance Through Profit Shifting

*Tracy A. Kaye**

I. CURRENT STATE OF AFFAIRS

On March 12, 2014, the Bloomberg News headline read *Cash Abroad Rises \$206 Billion as Apple to IBM Avoid Tax*.¹ The article goes on to note that U.S. multinational corporations “have accumulated \$1.95 trillion outside the U.S., up 11.8 percent from” last year, with the offshore profits of Apple Inc., Microsoft Corp., and International Business Machines Corp. comprising 18.2% (\$37.5 billion) of the total increase.² A tax and budget advocate at the U.S. Public Interest Research Group stated that “[t]he loopholes in our tax code right now give such a big reward to companies that use gimmicks to make it look like they earn their profits offshore.”³

This press coverage is important because public perception matters to legislators on Capitol Hill and the public is becoming increasingly aware of the corporate tax avoidance issue. In fact, there is global concern that U.S. multinationals are using transfer pricing rules and other techniques to shift reported income to low-tax countries without actually changing where they invest their resources.⁴ Profit shifting allows U.S. multinationals to maintain their actual investments in high-tax countries that have the appropriate infrastructure and labor forces necessary for actual business operations but report profits

* Professor of Law, Eric Byrne Research Fellow, Seton Hall University School of Law. B.S., University of Illinois; M.S.T., DePaul University; J.D., Georgetown University Law Center. I would like to gratefully acknowledge the research assistance of Yasmine Fulena, David Marella, Stephanie Pisko, and Trang Nguyen as well as the financial support provided by the Seton Hall University School of Law Dean’s Research Fellowship program and the *Chapman Law Review* Symposium.

¹ Richard Rubin, *Cash Abroad Rises \$206 Billion as Apple to IBM Avoid Tax*, BLOOMBERG, Mar. 12, 2014, <http://www.bloomberg.com/news/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html> (“The largest U.S.-based companies added \$206 billion to their stockpiles of offshore profits last year, parking earnings in low-tax countries until Congress gives them a reason not to.”).

² *Id.*

³ *Id.*

⁴ See CONG. BUDGET OFFICE, PUB. NO. 4150, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS 2 (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/43764_MultinationalTaxes_rev02-28-2013.pdf.

in tax havens or low-tax jurisdictions. This tax avoidance is accomplished by transfers of intellectual property or intangibles to low-tax jurisdictions, the allocation of debt to high-tax countries, and transfer pricing strategies with respect to goods.⁵

The United States's transfer pricing rules (section 482 and the accompanying Treasury regulations)⁶ require that the pricing of sales and services transactions between members of the multinational group use an arm's length standard in order to protect the U.S. tax base. These rules are necessary to ensure that taxpayers do not shift income properly attributable to the United States to a related foreign company.⁷ However, a 2013 Congressional Research Service (CRS) study states that U.S. multinationals "reported earning 43% of their overseas profits in the country group comprised of Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland" in 2008, while only 4% of their foreign employees and 7% of their foreign investment was located in those jurisdictions.⁸ On the other hand, Australia, Canada, Germany, Mexico, and the United Kingdom only accounted for 14% of their overseas profits with 40% of foreign employees and 34% of foreign investment located in these jurisdictions.⁹ All this evidence strongly indicates profit shifting. Furthermore, a 2008 Government Accountability Office study noted that 83% of the 100 largest publicly traded U.S. corporations have subsidiaries in tax havens or banking secrecy jurisdictions.¹⁰

It is clear that the transfer pricing rules are not functioning as intended. The Internal Revenue Service estimates that it is involved in income shifting controversies with respect to approximately 250 taxpayers involving \$68 billion in potential

⁵ JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 8–11 (2013), available at <http://www.fas.org/sgp/crs/misc/R40623.pdf>.

⁶ All section references are to the Internal Revenue Code of 1986, as amended.

⁷ STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 5 (Comm. Print 2010), available at <https://www.jct.gov/publications.html?func=startdown&id=3692>. "Absent transfer pricing rules, the lack of external market forces would permit multinational groups to shift income in any manner they choose among group members." *Id.* at 18.

⁸ MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42927, AN ANALYSIS OF WHERE AMERICAN COMPANIES REPORT PROFITS: INDICATIONS OF PROFIT SHIFTING 4–5 (2013), available at <https://www.fas.org/sgp/crs/misc/R42927.pdf>.

⁹ *Id.*

¹⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-157, INTERNATIONAL TAXATION: LARGE U.S. CORPORATIONS AND FEDERAL CONTRACTORS WITH SUBSIDIARIES IN JURISDICTIONS LISTED AS TAX HAVENS OR FINANCIAL PRIVACY JURISDICTIONS 4 (2008), available at <http://www.gao.gov/new.items/d09157.pdf>.

income adjustments.¹¹ Furthermore, these transfer pricing problems are particularly acute where intellectual property and other intangibles are involved.¹² At a hearing held in May 2013, the Permanent Subcommittee on Investigations (PSI) of the U.S. Senate Homeland Security and Governmental Affairs Committee heard testimony on the shifting of profits offshore by U.S. multinationals. The PSI's report explained how Apple Inc. shifted billions of profits to Ireland where it had "negotiated a special corporate tax rate of less than two percent" by "transferr[ing] the economic rights to its intellectual property through a cost sharing arrangement" with its offshore subsidiaries.¹³ A cost sharing agreement allows "related entities to share the cost of developing an intangible asset and a proportional share of the rights to the intellectual property that results."¹⁴ The Treasury Department estimated the potential loss of revenues to the government from this profit shifting as ranging between \$10 billion to \$80 billion annually,¹⁵ while a CRS study that summarized the economic research reported approximate revenue losses between \$30 billion to \$90 billion a year.¹⁶

British, French, and Italian revenue agencies have also been scrutinizing the various American companies known as GAFA (Google, Amazon, Facebook, and Apple).¹⁷ The French government has even published an expert report on the taxation issues of the digital economy, calling for "urgent action."¹⁸ In June 2012, the G-20 declared that base erosion and profit

¹¹ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 6 (2013) (written testimony of Samuel M. Maruca, Director, Transfer Pricing Operations, Internal Revenue Serv.), available at <http://www.hsgac.senate.gov/download/?id=35c9f013-0b45-43d7-809a-1737db468345>.

¹² See generally U.S. DEPT OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 1 (2007), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf>.

¹³ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 2 (2013) [hereinafter *PSI Report*] (memorandum from Sen. Carl Levin, Chairman, and Sen. John McCain, Ranking Minority Member, Permanent Subcomm. on Investigations), available at http://www.levin.senate.gov/download/exhibit1a_profitshiftingmemo_apple.

¹⁴ *Id.* at 7–8.

¹⁵ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 3 (2013) (written testimony of Mark Mazur, Assistant Secretary for Tax Policy, U.S. Dep't of the Treasury), available at <http://www.hsgac.senate.gov/download/?id=28f352a5-87d2-4c16-9262-ca629ab17fe8s>.

¹⁶ KEIGHTLEY, *supra* note 8, at 1–2 (citations omitted).

¹⁷ See *id.* at 2–3; see also Rubin, *supra* note 1.

¹⁸ PIERRE COLLIN & NICOLAS COLIN, TASK FORCE ON TAXATION OF THE DIGITAL ECONOMY 3 (2013). For a summary of the report, see Alberto Pluviano, *The French Government Report on the Taxation of the Digital Economy*, 10 DIRITTO E PRATICA TRIBUTARIA INTERNAZIONALE 97 (2013).

shifting must be prevented and called upon the Organization for Economic Cooperation and Development (OECD) to get involved in this issue.¹⁹

II. OECD BASE EROSION AND PROFIT SHIFTING PROJECT

The OECD issued a report on base erosion and profit shifting (BEPS) in February 2013. This BEPS report reviews various data and studies, finding an increased separation between the locations of the actual business activities and the reporting of profits for tax purposes.²⁰ The OECD followed up this report in July 2013 with an Action Plan of fifteen steps to address profit shifting by multinational corporations and move toward international coherence in corporate income taxation.²¹ The OECD BEPS Action Plan targets harmful tax practices by establishing a working party on aggressive tax planning and by requiring disclosure of aggressive tax planning arrangements as well as the global allocation among countries of the income, economic activity, and taxes paid to the relevant tax administrations.²² Actions 8–10 focus on various transfer pricing issues, including those with respect to intangibles, so as to “[a]ssure that transfer pricing outcomes are in line with value creation.”²³

The OECD BEPS Action Plan seeks to realign taxation with the relevant economic substance and ensure that taxable profits cannot be artificially shifted.²⁴ By the end of 2015, expect recommendations for revisions to domestic tax laws, the OECD Model Tax Convention, the Commentary to the OECD Model Tax Convention, and the OECD Transfer Pricing Guidelines, as well as the development of a multilateral instrument to facilitate implementation of these recommendations.²⁵ The OECD’s Committee on Fiscal Affairs has already released for public comment, discussion drafts of the tax issues surrounding the digital economy, hybrid entities and instruments, and transfer pricing guidelines for intangibles, along with a discussion draft on preventing treaty abuse.

¹⁹ The OECD is a fifty-year-old influential forum where over thirty governments, including the United States, come together to discuss tax and economic policy, among other topics, and set international standards.

²⁰ OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING 15 (2013).

²¹ OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter OECD BEPS ACTION PLAN].

²² See *id.* Action 5, at 18, Actions 11–12, at 21–22.

²³ *Id.* Actions 8–10, at 20.

²⁴ *Id.* at 13–14.

²⁵ *Id.* Action 15, at 24–25.

In 2013, G-20 finance ministers unanimously endorsed the OECD BEPS Action Plan at their July 20 meeting in Moscow,²⁶ as did the G-20 Leaders on September 6.²⁷ Note that the G-20 includes countries such as China, India, Saudi Arabia, Russia, Brazil, Indonesia, South Africa, and Argentina that are not members of the OECD but may participate in this project as Associates “on an equal footing with OECD members.”²⁸

III. UNITED STATES PARTICIPATION AND PROPOSALS

The United States issued a joint statement with the Nordic countries at the G-20 Summit in Russia supporting the OECD efforts on base erosion and profit shifting issues and is actively participating in the BEPS project.²⁹ In 2012, President Obama issued *The President’s Framework for Business Tax Reform*, declaring that “empirical evidence suggests that income-shifting behavior by multinational corporations is a significant concern that should be addressed through tax reform.”³⁰ The Permanent Subcommittee on Investigations of the U.S. Senate Homeland Security and Governmental Affairs Committee has recommended strengthening the transfer pricing rules with respect to intellectual property as well as various Subpart F reforms.³¹ Senator Carl Levin, Chairman of the PSI, reintroduced his legislation, the Stop Tax Haven Abuse Act, in September 2013 to “[l]imit incentives to move intellectual property and related marketing rights offshore”³² A CRS report on tax havens

²⁶ Kevin A. Bell, *G-20 Finance Ministers Meeting in Moscow Unanimously Back Anti-Evasion Action Plan*, INT’L TAX MONITOR, July 24, 2013, at 8.

²⁷ *G20 Leaders’ Declaration*, G20 (Sept. 6, 2013), <http://www.g20.org/news/2013/0906/782776427.html> (“We fully endorse the ambitious and comprehensive Action Plan—originated in the OECD—aimed at addressing base erosion and profit shifting We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created.”).

²⁸ See OECD BEPS ACTION PLAN, *supra* note 21, at 25.

²⁹ *Joint Statement by Kingdom of Denmark, Republic of Finland, Republic of Iceland, Kingdom of Norway, Kingdom of Sweden, and the United States of America*, WHITE HOUSE OFF. PRESS SECRETARY (Sept. 4, 2013), <http://www.whitehouse.gov/the-press-office/2013/09/04/joint-statement-kingdom-denmark-republic-finland-republic-iceland-kingdo>.

³⁰ THE WHITE HOUSE & DEPT’ OF THE TREASURY, *THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM 7* (2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>.

³¹ *PSI Report*, *supra* note 13, at 6. The Subpart F regime requires current U.S. taxation on the domestic parent corporation for certain types of income earned by certain foreign corporations known as controlled foreign corporations. See I.R.C. §§ 951–964. Subpart F defines which income is not eligible for the deferral regime: for example, income from the sales of foreign property to related parties. I.R.C. § 951.

³² *Summary of the Levin-Whitehouse-Begich-Shaheen Stop Tax Haven Abuse Act S. 1533*, CARL LEVIN U.S. SENATOR MICH. (Sept. 19, 2013), <http://www.levin.senate.gov/newsroom/press/release/summary-of-the-levin-whitehouse-begich-shaheen-stop-tax-haven-abuse-act>.

summarizes the numerous policy options available to address corporate profit shifting.³³

International tax reform proposals in the Administration's Fiscal Year 2015 budget released March 2014 include the current taxation of excess returns associated with transfers of intangibles offshore, the creation of a new category of Subpart F income for transactions involving digital goods or services, as well as deferral of the interest expense deduction related to the deferred income of the foreign subsidiaries of U.S. multinational corporations.³⁴ Other changes to discourage the shifting of profits offshore include restricting the use of hybrid arrangements that create stateless income and limiting the shifting of income through intangible property transfers.³⁵ The proposals to reform the U.S. international tax system would raise approximately \$276 billion from U.S. multinationals over the next ten years.³⁶ No one expects these provisions to be enacted immediately, but they are an important message to the international community as to the U.S. Administration's preferred solutions to the BEPS problem!

CONCLUSION

The United States is facing serious issues with respect to the base erosion and income shifting problems outlined in the BEPS Report and testimony given at the *Hearings on Offshore Profits Shifting Before the Senate PSI*. These issues need to be substantively addressed before any effort should be made on proposals to exempt foreign income or to change the U.S. international tax regime to a territorial system. The United States should participate fully in the OECD's effort to address the base erosion problem and begin making the necessary adjustments to the U.S. international tax regime that currently enables U.S. multinational corporations to legally avoid corporate taxes. The regulatory and statutory fixes needed for the U.S. international tax regime have been identified and should be adopted.

³³ GRAVELLE, *supra* note 5, at 24–29.

³⁴ U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 45–46, 49–50, 58–59 (2014), *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

³⁵ *Id.* at 47, 61.

³⁶ *Id.* at 280.