JOINT COMMITTEE ON TAXATION
July 22, 2010
JCX-38-10

Testimony of the Staff of the Joint Committee on Taxation Before the House Committee on Ways and Means Hearing on Transfer Pricing Issues July 22, 2010

My name is Thomas A. Barthold. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present a summary of the staff's publication, JCX-37-10, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* that we submitted to the House Committee on Ways and Means.

Overview

Some studies suggest that multinational enterprises (both U.S.-based and foreign-based) may be able to shift income to low-tax jurisdictions, suggesting deficiencies in the application of transfer-pricing rules. While perhaps suggestive, these studies do not identify the mechanisms by which income shifting might occur. The Joint Committee staff concluded that a review of public and private documents for specific taxpayers might help explain how the interaction between business operations and tax planning by U.S. based multinational corporations could result in low reported average U.S. and worldwide tax rates by certain of those corporations.

The Joint Committee staff selected six U.S.-based multinational corporations to study, in part, on the basis of reports to their shareholders that each of the corporations had an effective (i.e., average) tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999. The six case studies do not represent a random selection of U.S.-based multinational corporations. The Joint Committee staff's discussion of issues is based upon the facts as reported and is not a commentary on the correctness of any specific position taken by the taxpayer. The Joint Committee staff does not view the case studies as an investigation of the tax position of any specific taxpayer, but rather views the case studies as facilitating the identification and discussion of business structures that may affect a taxpayer's U.S. and worldwide tax liability.

To discuss the relative sizes of items such as worldwide income, worldwide tax payments, royalty payments, and other aggregate dollar amounts, all case studies are presented as if each multinational corporation had average global revenue of $100 billion during the taxpayers' study period. While business structures are described, these may often represent simplified versions of the actual business structures that the Joint Committee staff found. The case studies are presented in a manner so as not to be associated with or identify directly or indirectly any particular taxpayer.

My testimony today highlights, in slides, the common elements from the case studies that are presented in more detail in JCX-37-10.

WAYS AND MEANS HEARING ON POSSIBLE INCOME SHIFTING AND TRANSFER PRICING

Joint Committee on Taxation

July 22, 2010

Overview of Case Study Selection Process

- Review of public documents filed by over 100 public corporations with significant operations and sales both in the United States and abroad

- Each of the six cases selected had an effective (i.e., average) tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999

- These case studies do NOT represent a random selection of U.S. based multinational companies

Selected Case Studies

Taxpayers selected from six different industries

Taxpayer	Industry
Alpha Company	Consumer Products
Bravo Company	Industrial Technology Products & Services
Charlie Company	Industrial Products
Delta Company	Technology-based Consumer Products
Echo Company	Technology-based Consumer Products
Foxtrot Company	Consumer Products

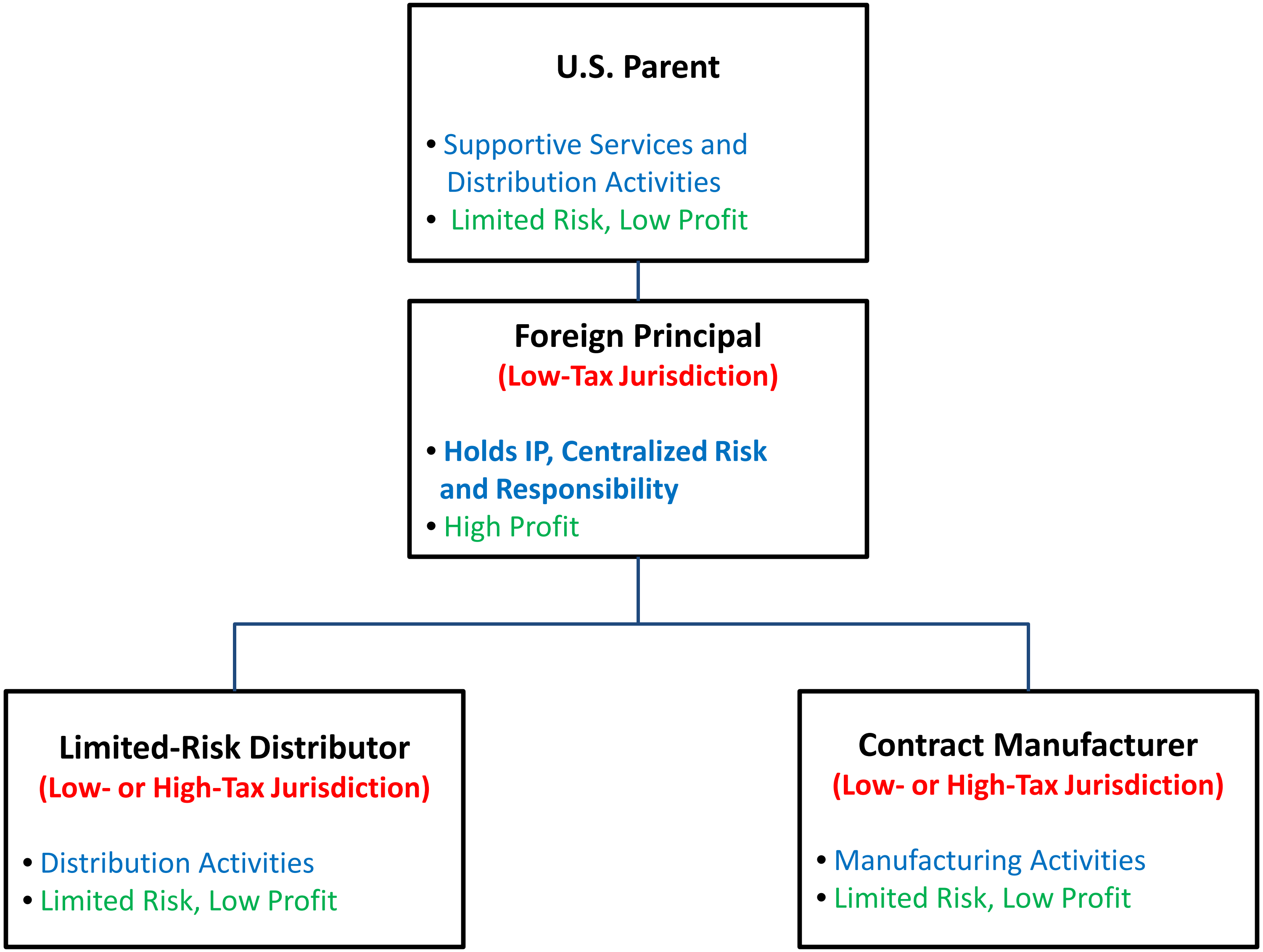
Common Features Among Case Studies

- Based on a review of publicly available U.S. GAAP financial data, Joint Committee Staff found the following common features
  - A significant portion of the income was earned offshore where it was subject to relatively low average foreign tax rates
  - Permanent reinvestment assertion for substantial amount of accumulated earnings offshore so that no U.S. tax is accrued for U.S. financial statement purposes
    - Median reported at end of 2008: $3 billion
  - U.S. pre-tax income as a percentage of worldwide pre-tax income was lower than U.S. sales as a percentage of worldwide sales

Common Features

Taxpayer	Average U.S. Sales as a % of Worldwide sales	Average U.S. Pre-Tax Income as a % of Worldwide Pre-Tax Income
Alpha Company	60%	Less than 30%
Bravo Company	50%	33%
Charlie Company	More than 60%	10%
Delta Company	45% to 55%	10%
Echo Company	More than 60%	40%
Foxtrot Company	Approximately 50%	Less than 10%

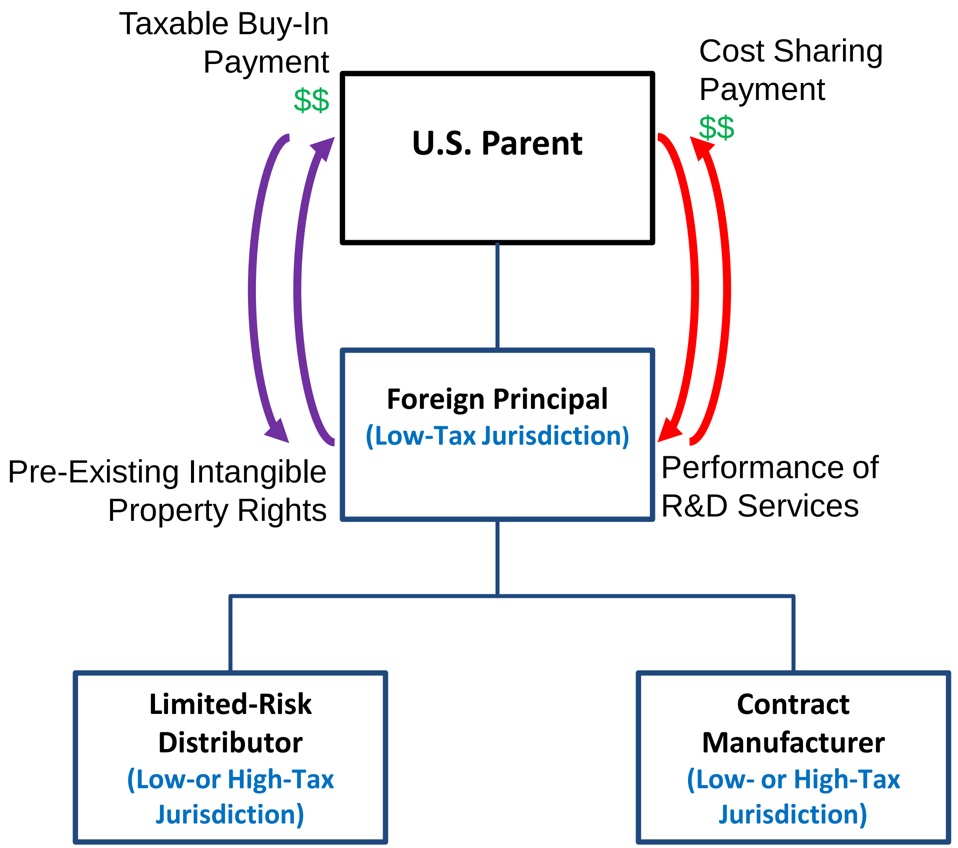
Principal Model of Business Structure



Principal Model of Business Structure

- Taxpayers following the principal model typically have a:
    - Concentration of more profitable functions in foreign jurisdictions where they can achieve a lower average tax rate
    - In jurisdictions where average tax rate is higher, presence may be limited to less profitable functions
- Valuation on intercompany pricing of all related-party transactions determines allocation of profit within the group
    - Contract manufacturing
    - Distribution
    - Supportive services

Cost Sharing



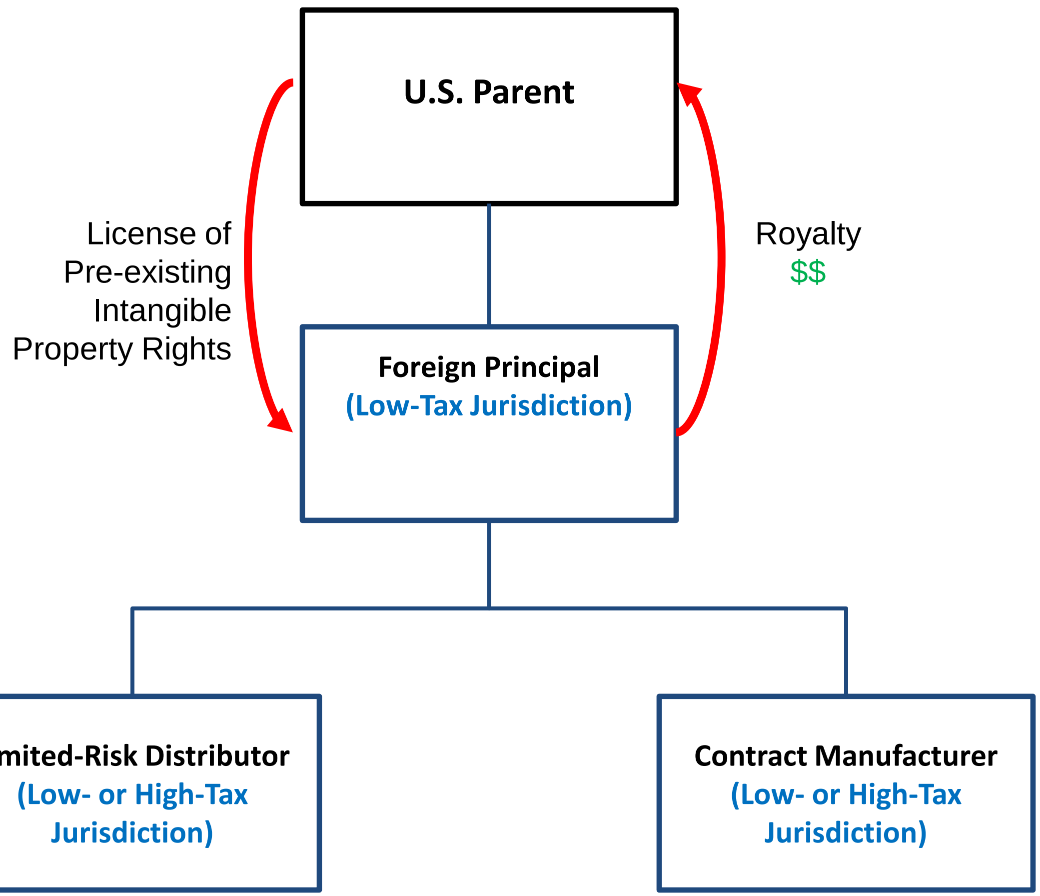
Cost Sharing

– Taxpayers exploit intangible property rights effectively as part of foreign operations

- Ownership: foreign principal buys into preexisting intangible property rights (e.g., patents) and share in the cost of future development of those rights
  - Examples of rights acquired
    - » Product lines
    - » Rights to sell in specific geographic area

- Valuation of preexisting intangible rights determines amount of buy-in payment (e.g., royalty)

Licensing


U.S. Parent
License of Pre-existing Intangible Property Rights
Royalty
$$
Foreign Principal
(Low-Tax Jurisdiction)
Limited-Risk Distributor
(Low- or High-Tax Jurisdiction)
Contract Manufacturer
(Low- or High-Tax Jurisdiction)

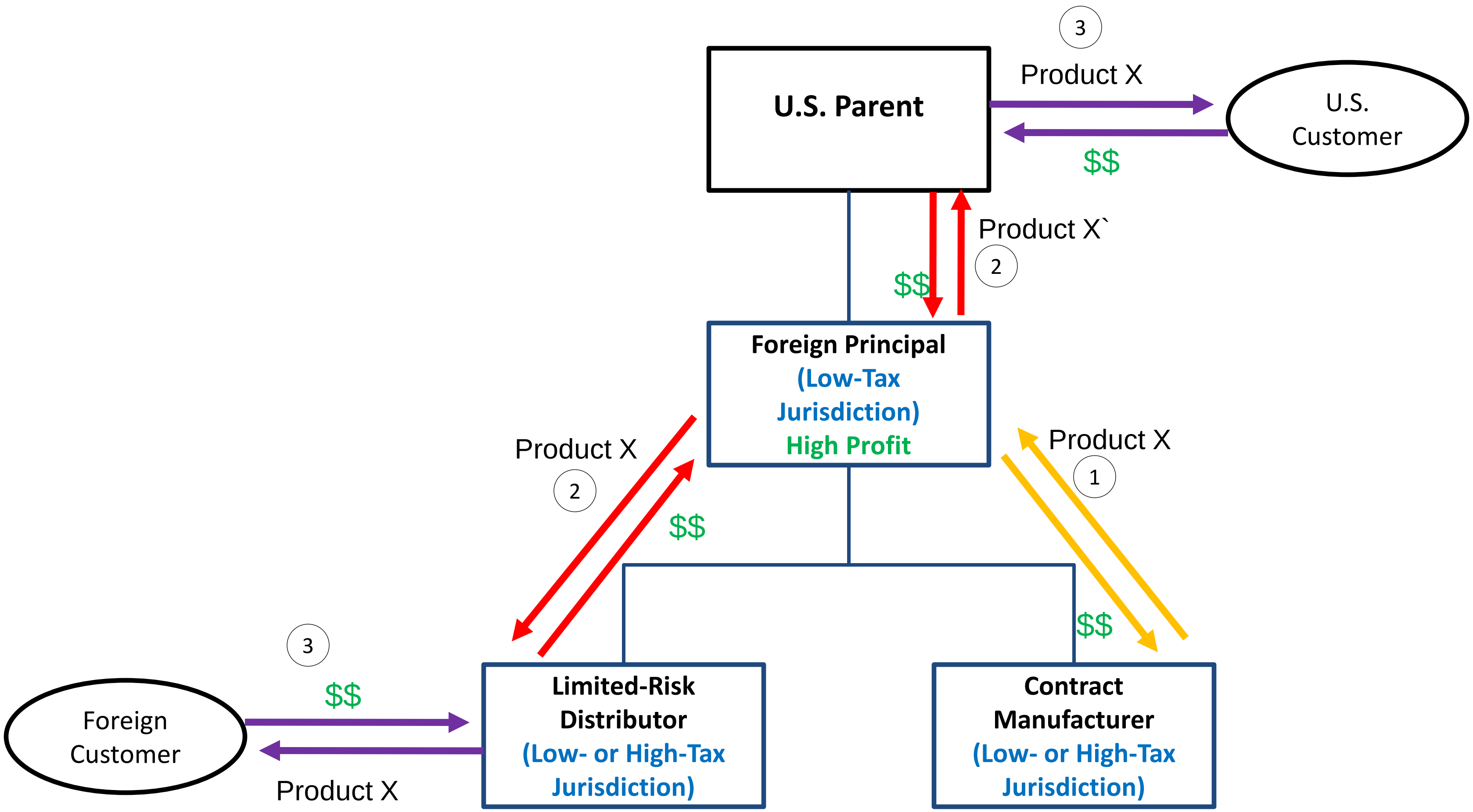
Licensing

- Taxpayers exploit intangible property rights effectively as part of foreign operations
    - License: foreign subsidiary enters into license agreement with U.S. group to make and sell certain product lines either solely outside U.S. or worldwide
    - Valuation of preexisting intangible rights determines royalty rate

Method of Intangible Property Transfer

Taxpayer	License vs. Cost Sharing
Alpha Company	License
Bravo Company	Cost Sharing
Charlie Company	License
Delta Company	License
Echo Company	License and Cost Sharing
Foxtrot Company	Cost Sharing

Foreign Value Chain



Managing Subpart F Exposure

- Subpart F foreign personal holding company income rules
  - Intercompany payments (e.g., royalties) received by controlled foreign corporations ("CFCs") may be subject to current taxation
  - Use of check-the-box rules and CFC look-through rules help ensure cross-border payments are not currently taxable
- Subpart F foreign base company sales income rules
  - Generally, income of a CFC from the purchase of personal property from a person outside the CFC's country of incorporation and its sale to a person outside the CFC's country of incorporation, where either person is related to the CFC
  - If CFC treated as manufacturer, no current U.S. taxation ("manufacturing exception")
  - Subject to certain branch rules, use of check-the-box helps facilitate meeting manufacturing exception and disregarding related-party sales

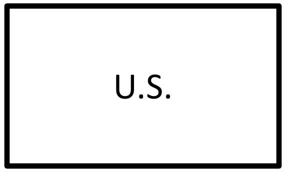
Recent Changes in U.S. Tax Laws with Potential Impact

- New cost sharing regulations
  - Now less attractive to migrate U.S. owned pre-existing intangible property rights offshore
  - Taxpayers that migrate U.S. owned pre-existing intangible property rights such as Bravo, Echo, and Foxtrot under old cost sharing regulations are grandfathered
  - No impact on taxpayers that enter into a license with their foreign principals such as Alpha and Delta

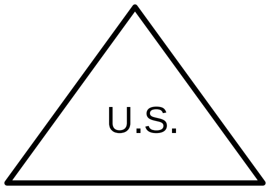
- New contract manufacturing and foreign branch manufacturing rules
  - Unable to rely solely upon contractual rights, legal title, tax ownership, and assumption of risk to meet manufacturing exception
  - Employees of CFC must make a substantial contribution to the manufacturing process
  - Nonphysical manufacturing on same footing with physical manufacturing

APPENDIX:
Summary of Bravo Company
and
Delta Company

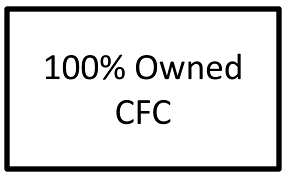
Legend



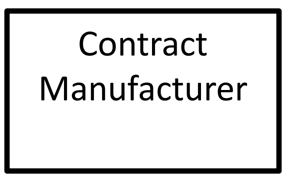
U.S. – Corporation



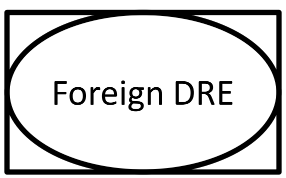
U.S. – Partnership



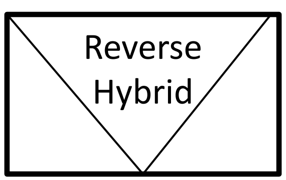
U.S. – Controlled foreign corporation (“CFC”)
Foreign - Corporation



U.S. – Unrelated service provider
Foreign – Unrelated service provider



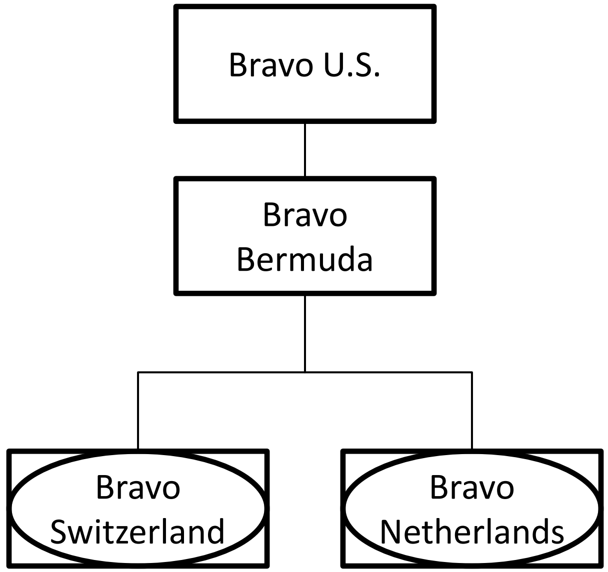
U.S. – Disregarded entity (“DRE”) (branch)
Foreign – Corporation



U.S. – Controlled foreign corporation
Foreign – Partnership (Flow -Through Entity)

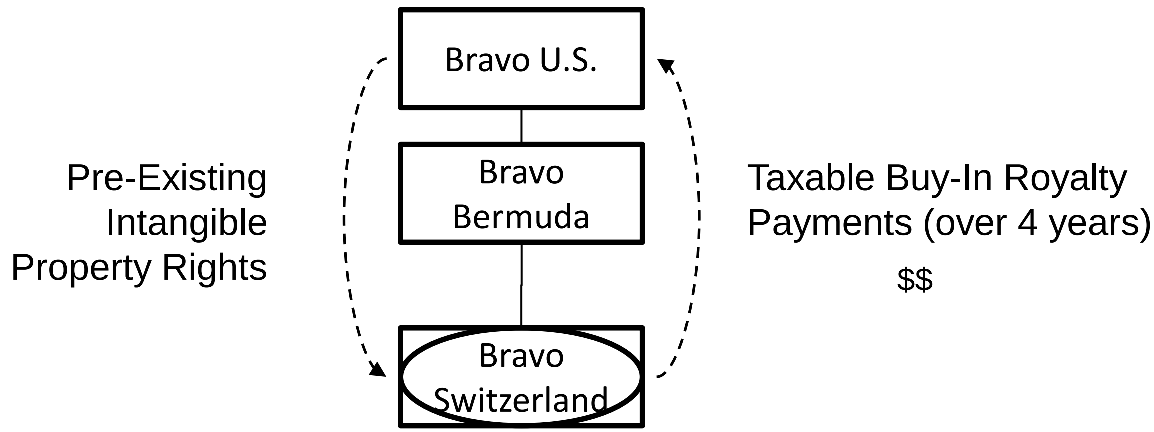
Bravo Company

Bravo Company: Key Foreign Entities



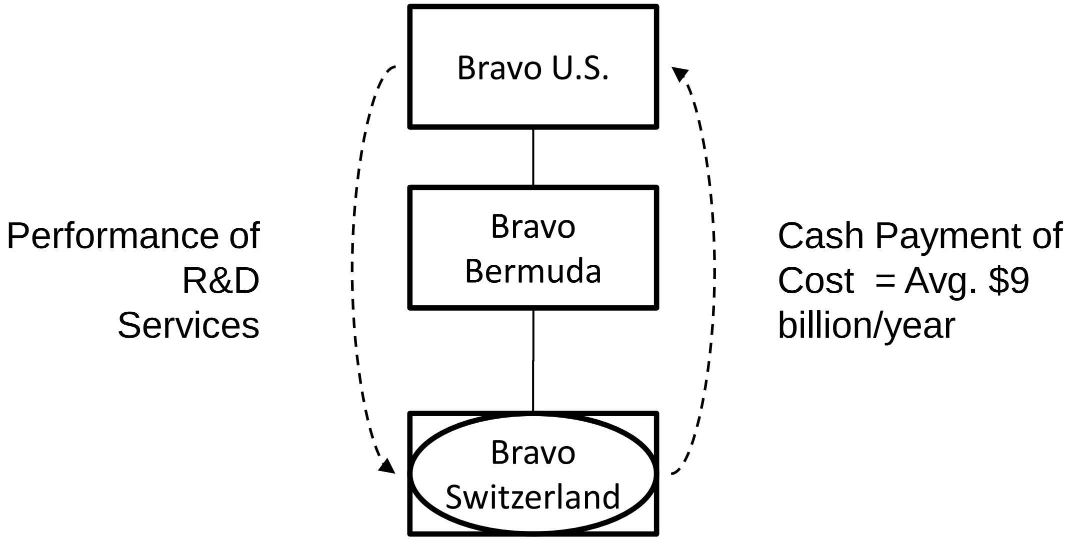
- Bravo Bermuda: CFC; foreign holding company
- Bravo Switzerland: DRE; economic owner of worldwide rights to certain Bravo IP
- Bravo Netherlands: DRE; foreign principal and licensor of IP

Bravo Company: Buy-In Payment



- To allow Bravo Switzerland to use pre-existing intangible property made available through cost sharing agreement, Bravo Switzerland made a buy-in payment to Bravo U.S.
- Results: U.S. taxable income; Swiss tax deduction

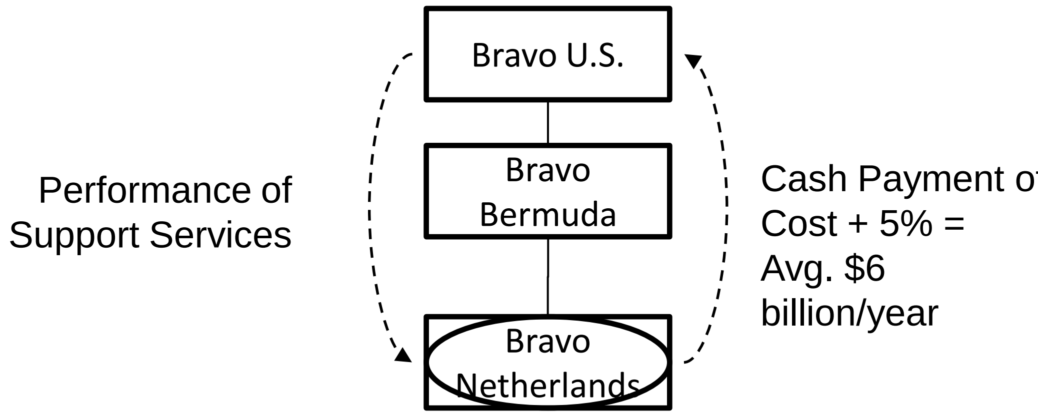
Bravo Company: Cost Sharing Arrangement



- Under a cost sharing agreement, Bravo Switzerland funded R&D performed by Bravo U.S. based on percentage of Bravo worldwide sales attributable to intangible property rights owned by Bravo Switzerland

- Results: U.S. taxable income offset by U.S. R&D deduction; may be eligible for U.S. R&D tax credit; Swiss tax deduction

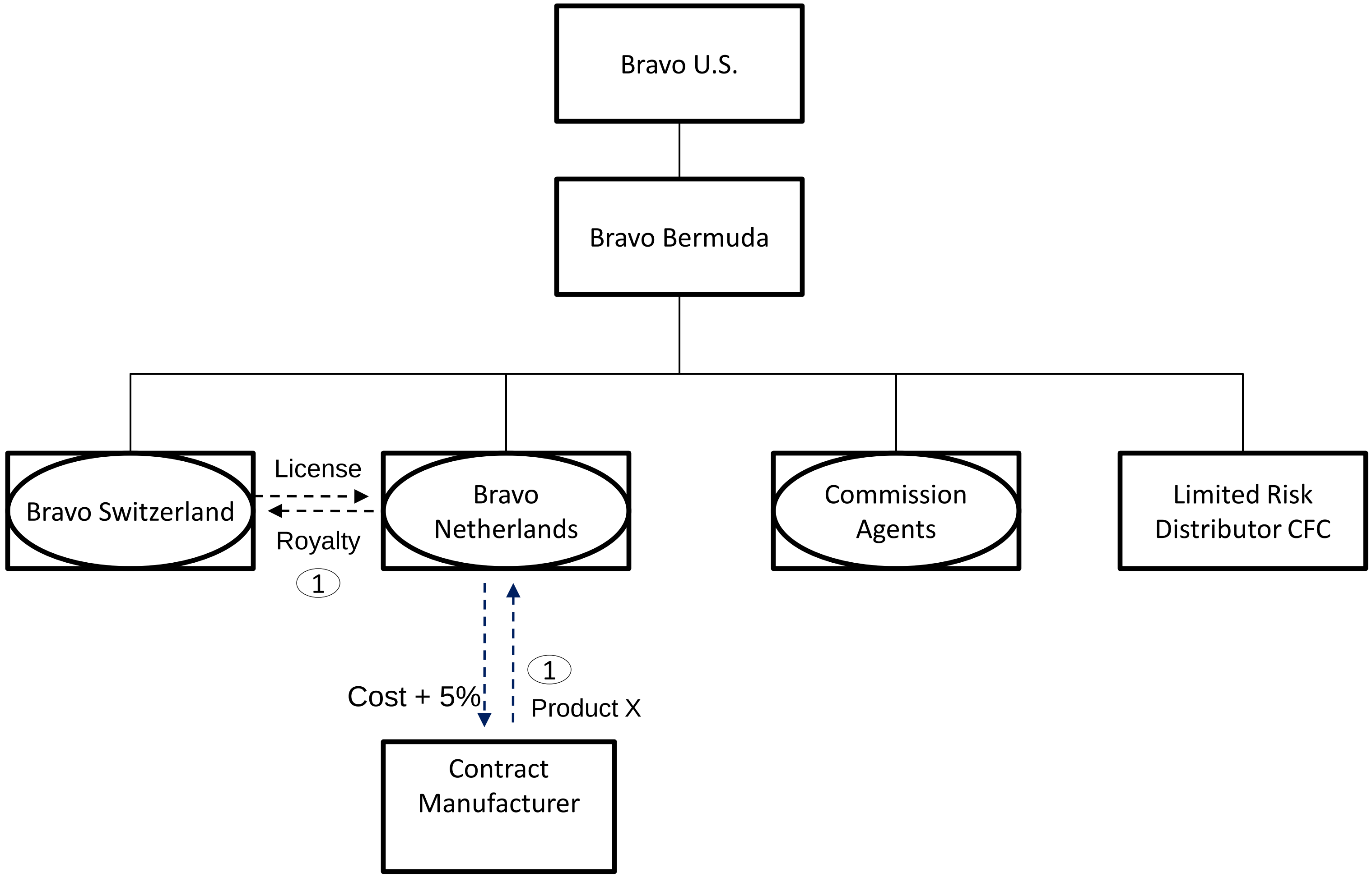
Bravo Company: Supportive Services



- Bravo Netherlands relies upon employees of Bravo U.S. to perform supportive services including (1) marketing and sales support; (2) factory, procurement, quality control, and similar services relating to manufacture of goods; (3) training, support, and professional services; and (4) treasury, tax, and other general and administrative services

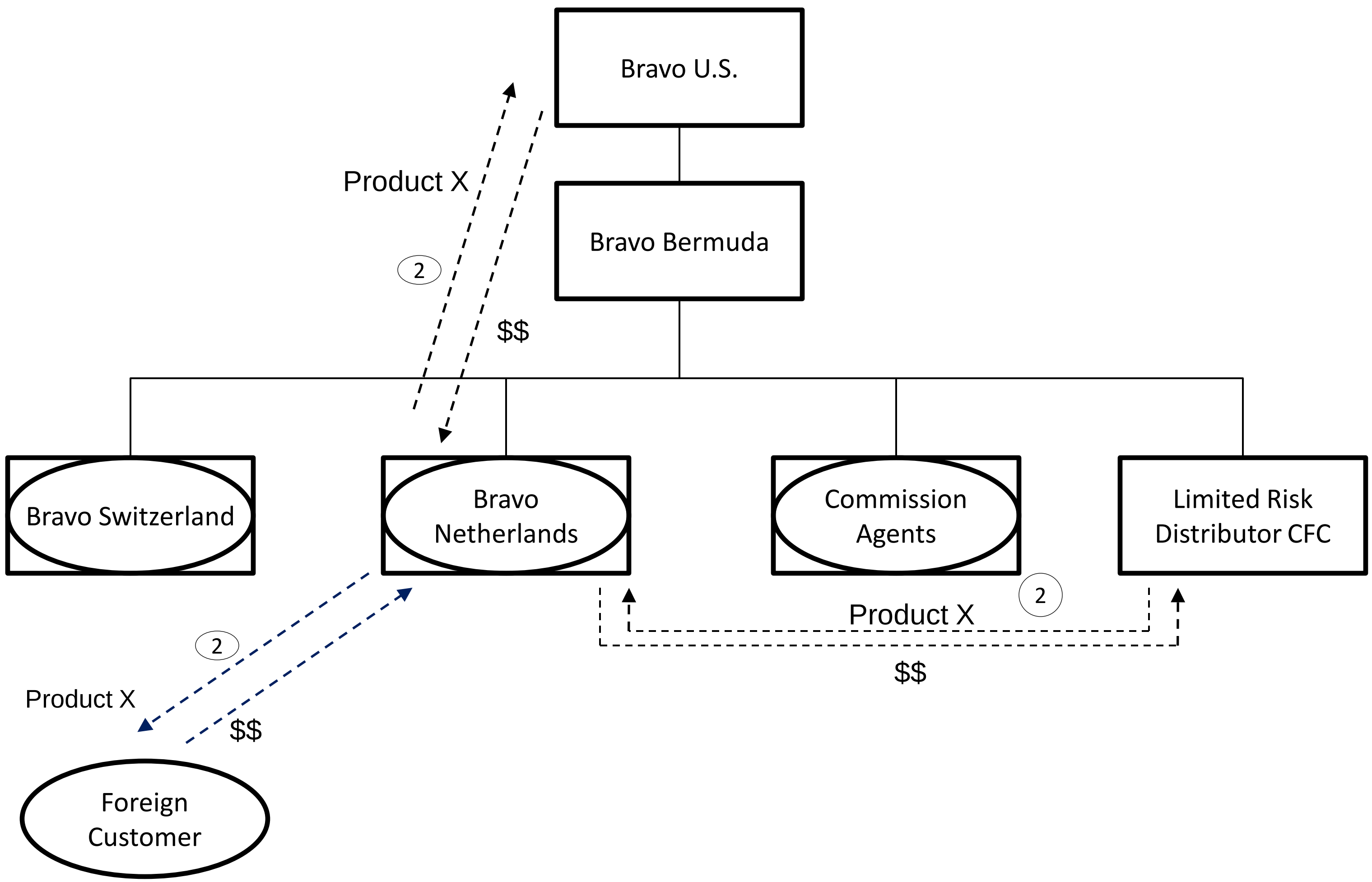
- Results: U.S. taxable income to the extent of mark-up; Dutch tax deduction

Step 1: Manufacturing of Product X



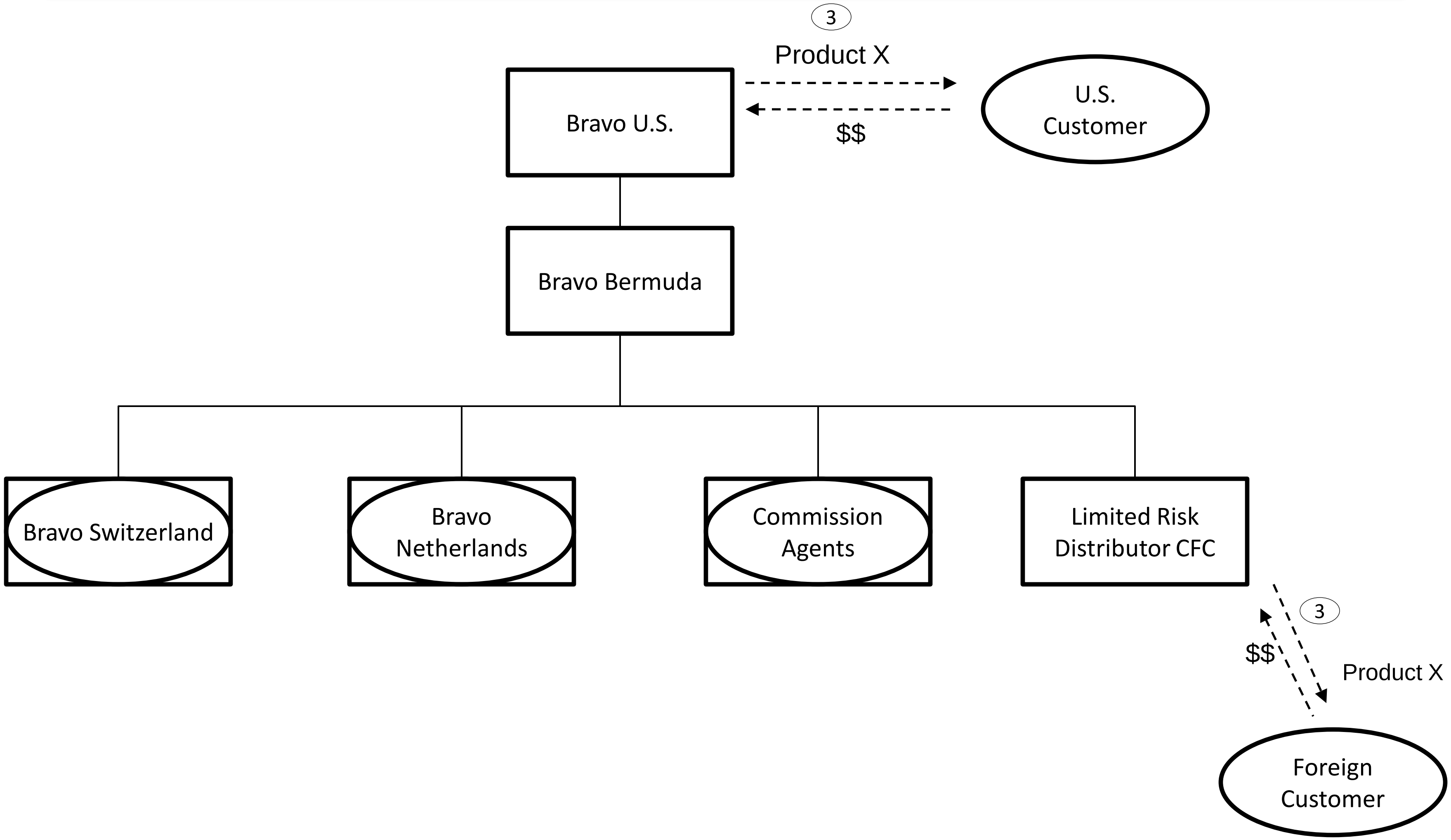
Step 1: Bravo Netherlands licenses intangible property rights from Bravo Switzerland and engages the 3rd party contract manufacturer to assist with manufacturing of Product X

Step 2: Sale to Foreign Customers, Bravo U.S., and CFC Distributors



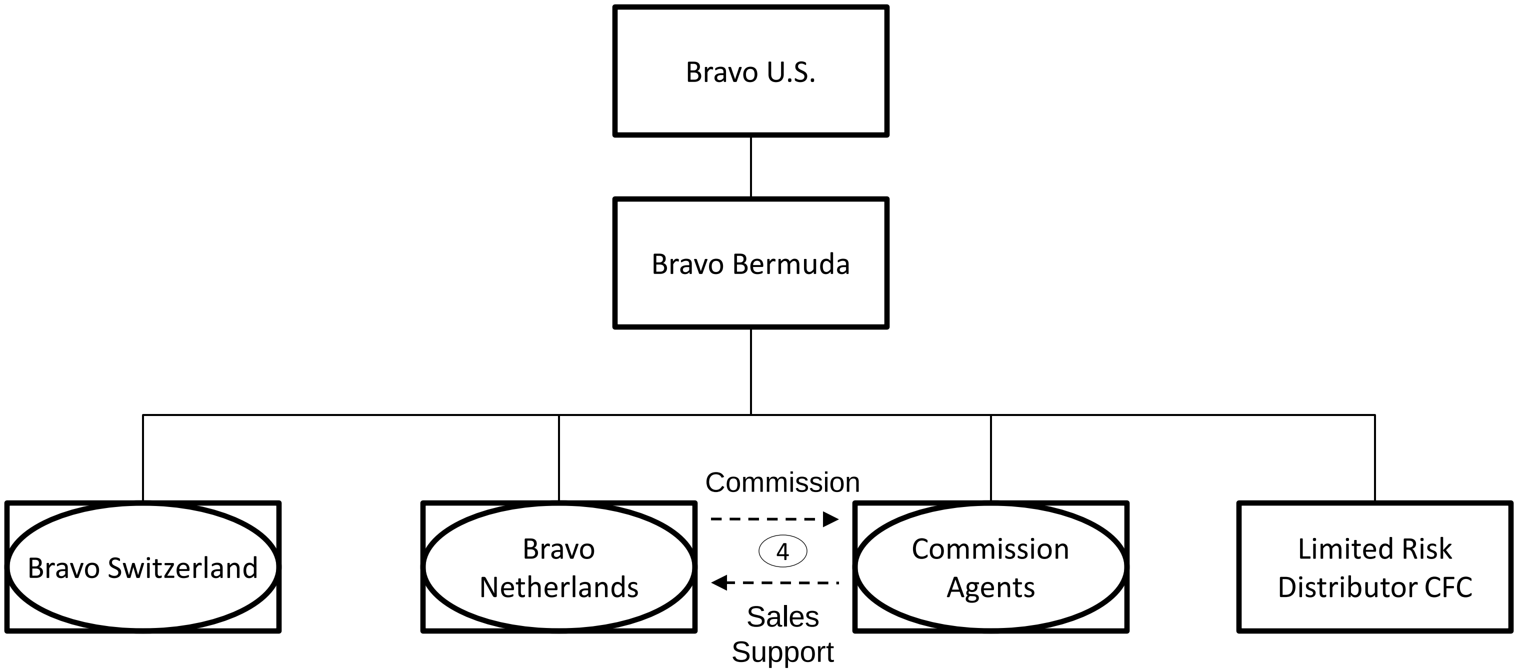
Step 2: Bravo Netherlands sells Product X directly to foreign customers as well as Bravo U.S. and the Bravo limited risk distributor CFCs

Step 3: Resale to U.S. and Foreign 3rd party Customers



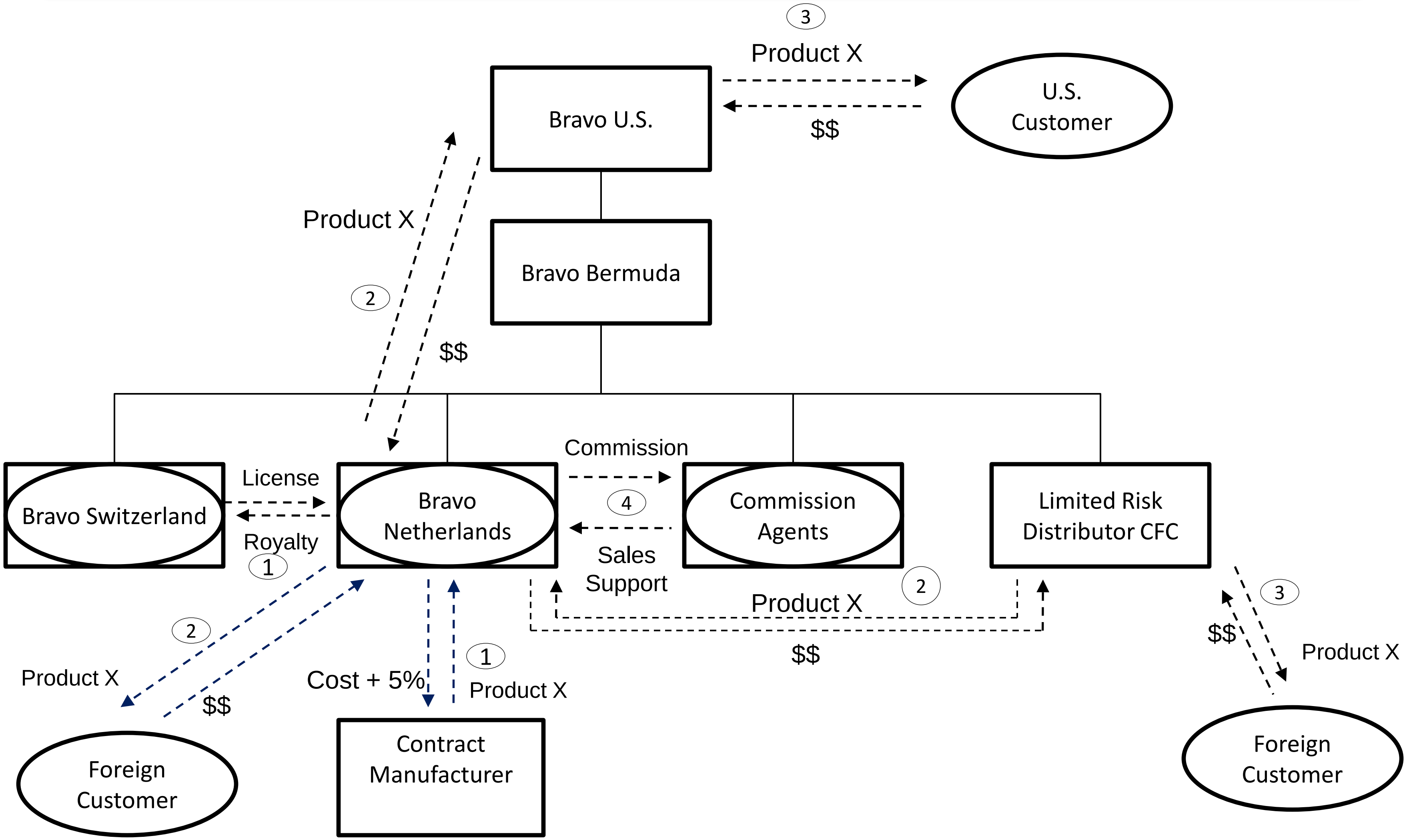
Step 3: Bravo U.S. and the Bravo limited risk distributor CFCs resell Product X to U.S. and foreign customers

Step 4: Commission Payment for Sales Support



Step 4: Bravo Netherlands makes a commission payment to European DRE commission agents for sales assistance

Summary of Transaction Flows



Note: The annual cost-sharing and supportive services payments are not featured on this slide.

Bravo Company: Recap

- Not pictured here, Bravo has a comparable structure in the U.S. that also uses domestic contract manufacturing

- With respect to foreign operations, the bulk of manufacturing and sales income accrues to Bravo Netherlands for serving as principal
  - Significant royalty paid to Bravo Switzerland for use of intangible property rights
  - Only limited amount of income subject to tax in Netherlands at 25% tax rate

- Royalty income received by Bravo Switzerland taxed at less than 5% tax rate

- From a U.S. tax perspective:

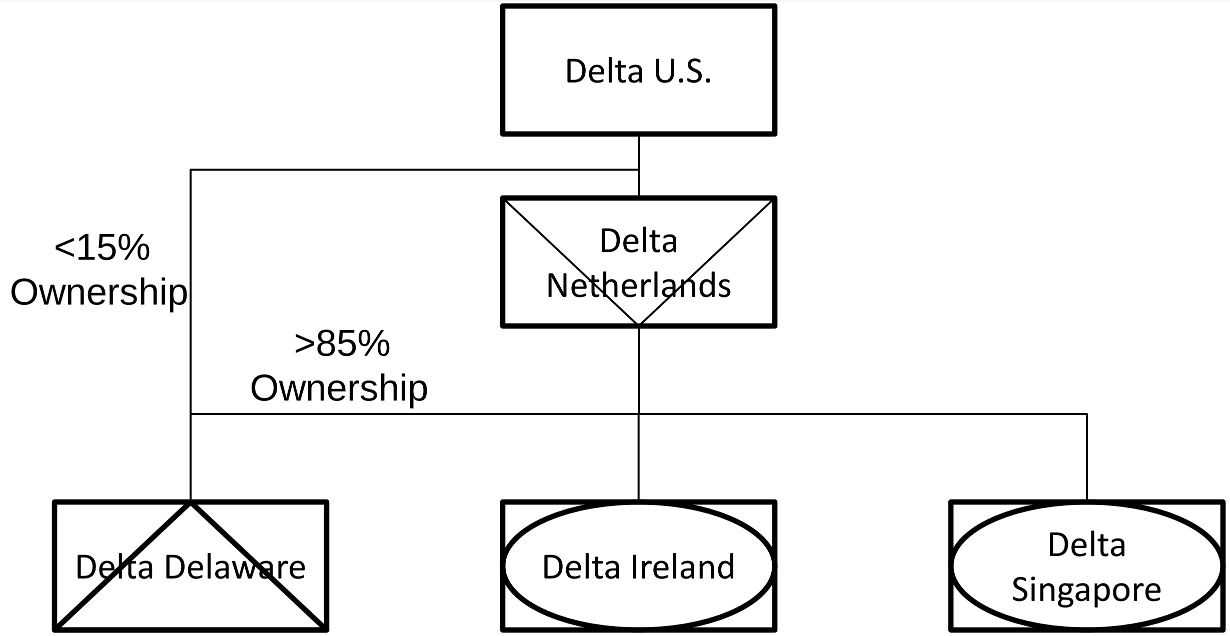
  - Bravo U.S. has taxable income for its limited risk distributor activities (2% return on sales) and performance of supportive services

  - No subpart F income due to:
    - Intragroup transactions (royalties and sales) being disregarded under Bravo Bermuda
    - Manufacturing exception to subpart F through attribution of third-party contract manufacturer activities

  - Significant portion of earnings permanently reinvested for U.S. GAAP purposes

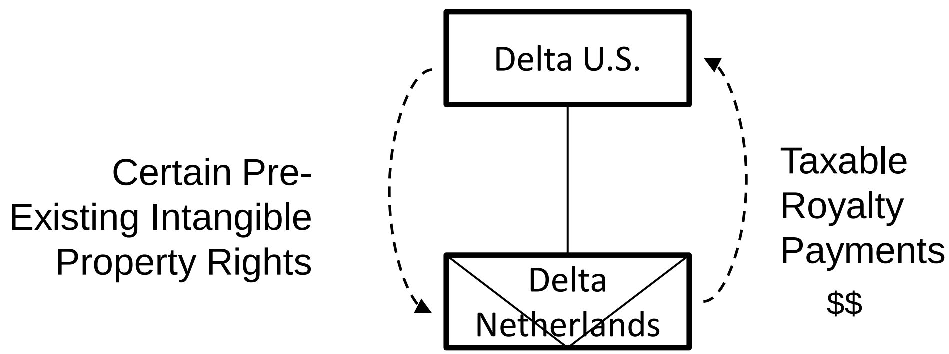
Delta Company

Delta Company: Key Foreign Entities



- Delta Netherlands: CFC; principal holding company for Delta's manufacturing operations
- Delta Delaware: Partnership for U.S. tax and corporation for foreign tax; operating company and licensee of certain Delta intangible property
- Delta Ireland: DRE; licensee of certain Delta intangible property and makes-sells products to Delta U.S. and foreign affiliates
- Delta Singapore: DRE; licensee of certain Delta intangible property and makes-sells products to Delta U.S. and foreign affiliates

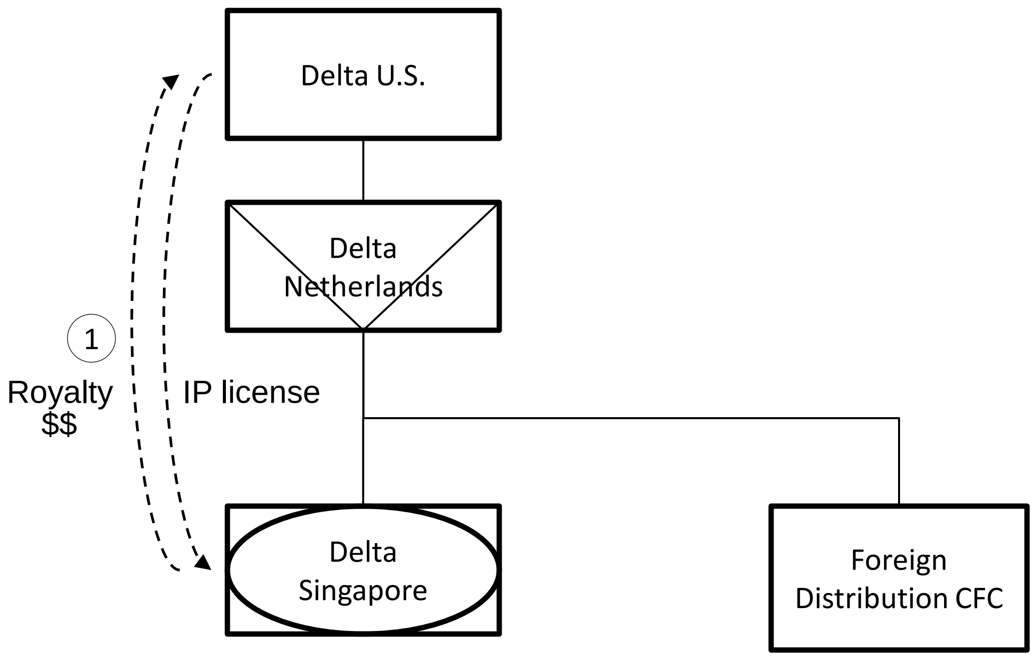
Delta Company: License Payment



- Delta U.S. often licenses rights to exploit intangible property attributable to new product after it is sufficiently developed but not market ready
    - Delta Netherlands bears financial burden for some minimal level of further R&D conducted by Delta U.S.
    - Helps justify lower royalty rate than if R&D for product was fully complete prior to the license

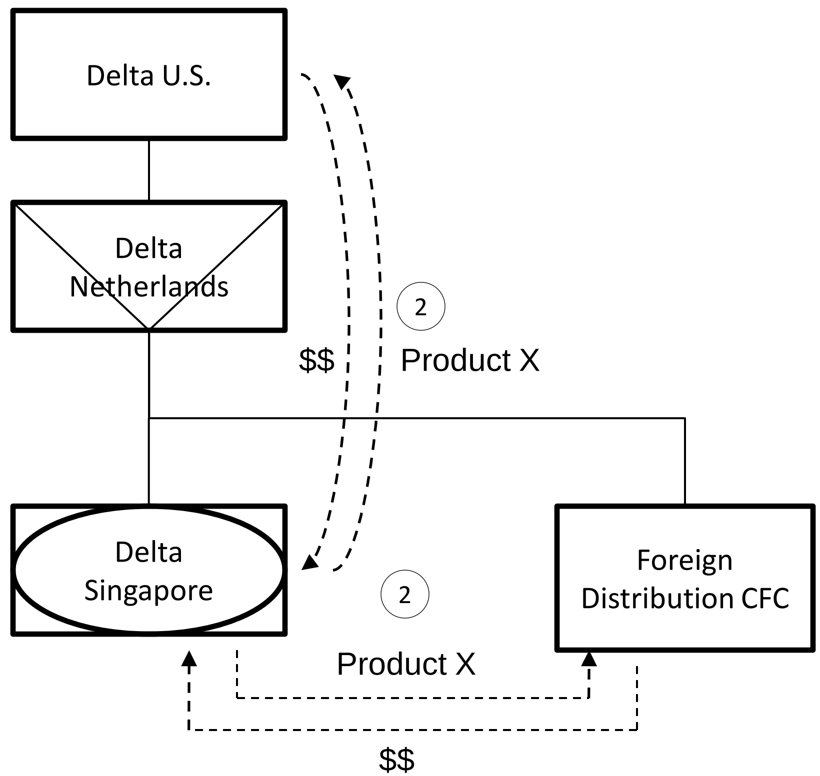
- Results: U.S. taxable income; Dutch tax deduction

Step 1: License of intangible property to Delta Singapore



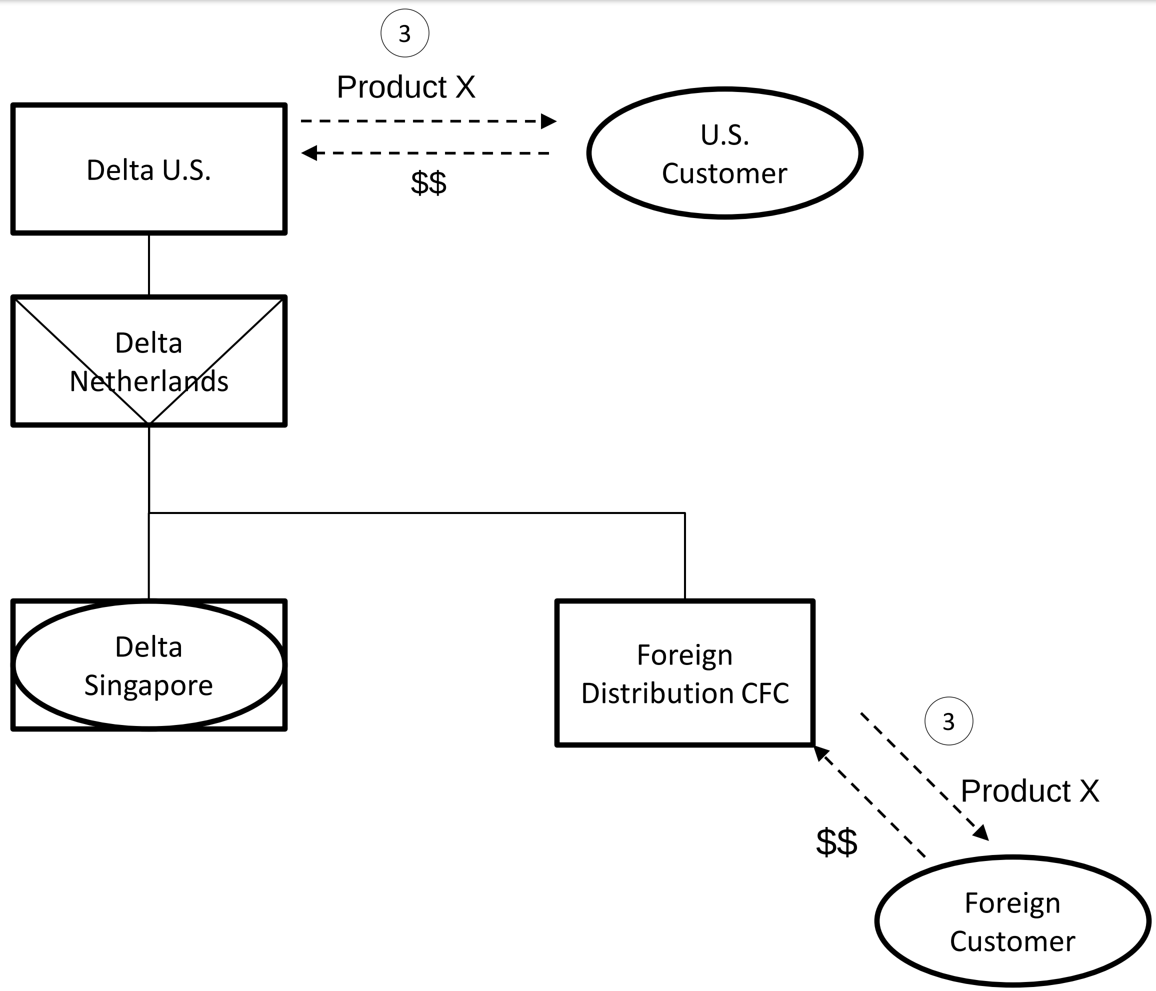
Step 1: Delta U.S. licenses product-related intangible property to Delta Singapore in return for a royalty payment

Step 2: Sale of Product X to Delta U.S. and Foreign Distribution CFC



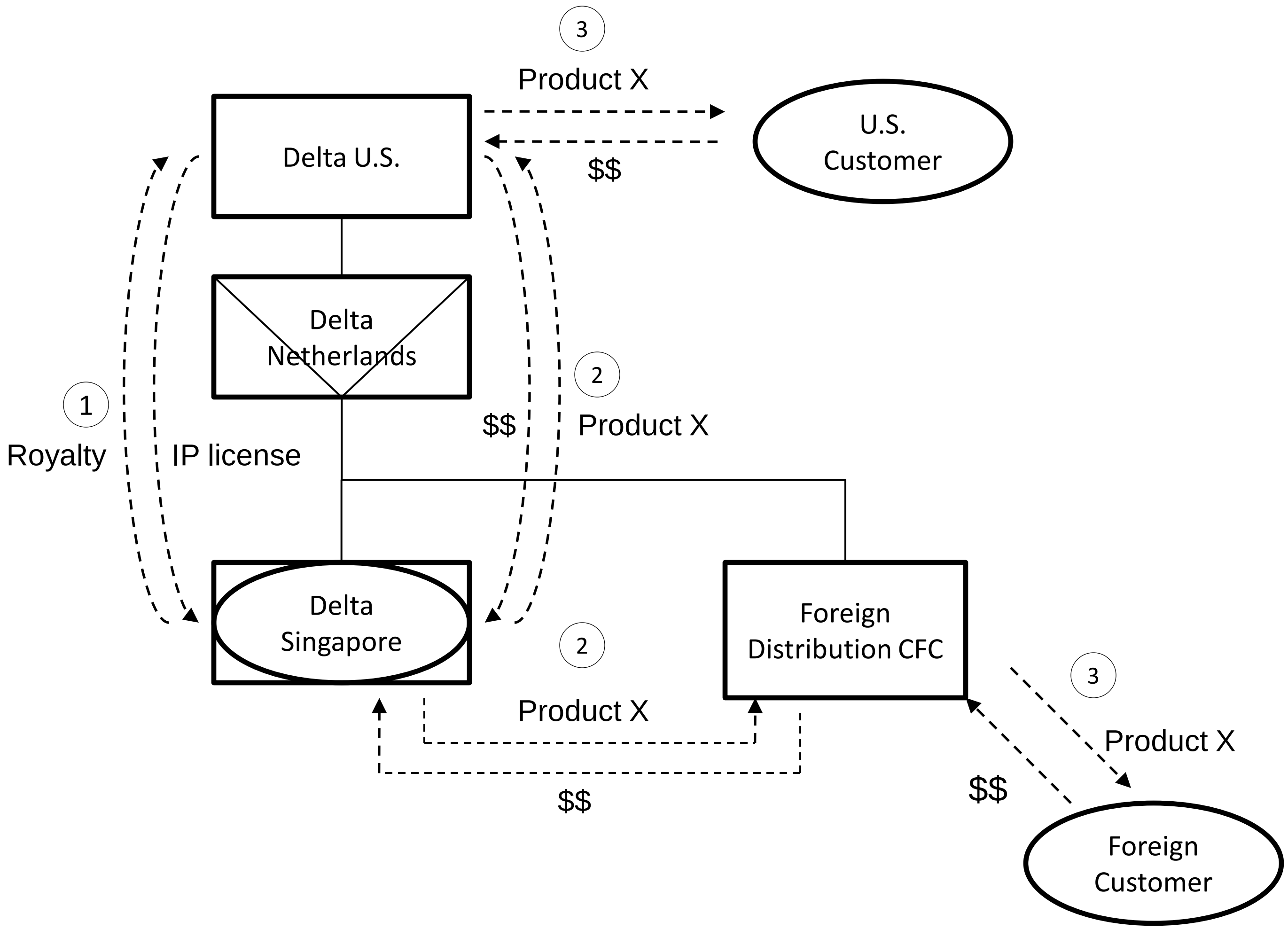
Step 2: Delta Singapore sells Product X to Delta U.S. and Foreign Distribution CFC

Step 3: Resale to U.S. and Foreign 3rd party Customers



Step 3: Delta U.S. and Foreign Distribution CFC resell Product X to U.S. and foreign customers

Summary of Transaction Flows



Delta Company: Recap

- Not pictured here, Delta has a comparable structure in the U.S. that also uses domestic manufacturing

- With respect to Delta's foreign operations, a substantial portion of profit resulting from the manufacture and sale of products retained by Delta Netherlands and its manufacturing DREs

    - Delta Netherlands average tax rate on earnings (including the earnings of its DREs) was approximately 5 percent over the study period

- From a U.S. tax perspective:

    - Delta U.S. has taxable income attributable to the licensing income it receives from Delta Netherlands and its distribution activities on behalf of Delta Netherlands

    - No subpart F income due to meeting manufacturing exception to subpart F

    - Significant portion of earnings permanently reinvested for U.S. GAAP purposes