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## Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 1

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## Profit-Shifting Structures: Making Ethical Judgments Objectively

*By Jeffery M. Kadet and David L. Koontz*

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## Profit-Shifting Structures: Making Ethical Judgments Objectively

by Jeffery M. Kadet and David L. Koontz



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Today's political classes from both sides of the aisle rail against tax loopholes that benefit large corporate taxpayers but then actively lobby for benefits for their favored industries and corporate

friends. The outcome is a complicated body of tax law containing special provisions that are seen as benefits by some and loopholes by others. This potent mixture of worldwide taxation, deferral, high tax rates, complicated rules, and special benefits is the fodder that has given rise to myriad sophisticated and inscrutable tax avoidance structures. With the complexity of the tax law encouraging profit-shifting strategies, how can nontax expert management and board members judge the propriety of the structures for which they're responsible?

This is a two-part report; Part 2 will appear in the July 4 issue of *Tax Notes*. In this first part of the report, Kadet and Koontz set out an ethical benchmark that multinational corporations can use to objectively test the propriety of their profit-shifting structures. This benchmark focuses more on business operations and less on tax rules. Even Apple's Tim Cook, Alphabet's Eric Schmidt, and other CEOs who strongly maintain that their companies pay every tax dollar they owe and comply with all tax laws could use this simple framework to understand if their tax structures comport with reality or depart from it.

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### I. Introduction

The issues of paying taxes and the ethics of legally avoiding them have been with us a very long time. Judge Learned Hand, in the Second Circuit opinion leading to the landmark 1935 Supreme Court decision in *Gregory*,<sup>1</sup> penned a few prescient words well known to tax practitioners:

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.<sup>2</sup>

<sup>1</sup>*Gregory v. Helvering*, 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

<sup>2</sup>*Id.*, 69 F.2d at 810.

Down through the years, many taxpayers have tenuously clung to this language and some of its progeny as judicial support for a proposition: If taxpayers can be so clever under almost any interpretation of the tax law as to arrange their affairs to pay less or no taxes, they must be regarded as being in full compliance with the law. Despite this language, *Gregory* is one of several cases that introduced powerful and troubling yet subjective tests for taxpayers and the IRS alike — the concepts of business purpose, substance over form, etc. Although many subsequent cases have focused on these subjective concepts, one aspect of the Supreme Court's *Gregory* decision was the need for consistency between the taxpayer's actions and the intent of the underlying statute.<sup>3</sup> Congress's recent codification of the economic substance judicial doctrine, leaving in place all prior case law, has left this aspect of the 1935 decision untouched while significantly tightening penalty provisions when this doctrine applies.<sup>4</sup>

Following this landmark case, U.S. tax lore is now replete with cases in which the government has used these judicial concepts against taxpayers who have engaged in almost every kind of transaction imaginable. Sometimes the government has succeeded, and sometimes it has not. The subjectivity of these concepts has failed to provide any bright-line tests for either taxpayers or the government. If these judicial concepts were intended to act as a constraint on taxpayers' behavior, there is little evidence that they have had the desired effect. In fact, the subjectivity of these concepts has arguably provided a façade of legitimacy for many abusive tax structures. This is particularly true for many of the aggressive profit-shifting arrangements, implemented by some multinational corporations (MNCs), that have become so prevalent over the past several decades.

There is no need here to reexamine these judicial concepts under some new powerful modern-day

microscope. Rather, after setting out some background information on profit shifting and international tax mechanisms, this report has two goals:

- Using an MNC's factual situation, the report defines an objective, ethical benchmark by which an MNC's board members and management, who are not tax experts, may test the acceptability of specific profit-shifting structures. This means that boards and senior management (including some who strongly maintain that their groups pay every tax dollar owed and comply with all tax laws) could reasonably judge the propriety of some of the strongly criticized tax-motivated structures implemented by their organizations.<sup>5</sup>
- The second part of this report identifies actions to be considered for adoption by MNC boards, professional tax advisers, Congress, Treasury, and the IRS that could reduce profit shifting, improve MNC governance, and equalize the collection of taxes. These include several initiatives that Treasury and the IRS could institute without the need for congressional action.

This report is written solely from a U.S. perspective and is focused on whether U.S. tax is being inappropriately avoided by MNCs, whether they are based in the United States or elsewhere. It makes no attempt to answer whether tax has been avoided in other countries. However, when inappropriate profit shifting ultimately causes income to become taxable in the United States, the sometimes convoluted and costly efforts by MNCs to avoid other countries' taxes will have been for naught. When those structures fail and later result in high U.S. tax costs, MNCs should unwind their ill-advised profit-shifting arrangements. This should result in MNCs paying the appropriate tax in the countries where they operate or earn revenue and should allow more companies to compete on a level tax playing field.

## II. The Current Environment

### A. Profit-Shifting Structures

It is widely acknowledged that MNCs do not like paying taxes. However, it now seems clear that the MNCs that can most afford to pay taxes are the ones that can most afford not to. Published reports confirm that U.S.-based MNCs have stockpiled overseas more than \$2 trillion on which no U.S. tax

<sup>3</sup>The Supreme Court in *Gregory* stated:

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

293 U.S. at 470.

<sup>4</sup>See section 7701(o) and amendments to various penalty sections added by section 1409 of the Health Care and Education Reconciliation Act of 2010, P.L. 111-152.

<sup>5</sup>See KPMG LLP, "Tackling Tax Transparency" (2014) (KPMG 2014 survey finding that 25 percent of the 220 tax executive respondents said "their company's tax profile had been the subject of media reports in the past 12 months. This percentage jumped to more than 40 percent of respondents at companies with revenue of more than \$10 billion.").

has been paid.<sup>6</sup> Tax avoidance is not unique to the United States and its MNCs, but it has become as widespread as any health epidemic. The OECD's October 2015 final report on the measurement of base erosion and profit-shifting activity estimates that global revenue losses from underpaid corporate income taxes may be as high as \$240 billion annually.<sup>7</sup>

Some executives of large MNCs have confidently asserted that through efficient and judicious tax planning and shrewd business judgment, they are able to beat the system and are inoculated against any adverse reactions from placing so much untaxed income beyond the reach of the U.S. tax authorities.<sup>8</sup> Perhaps true, but like so much that is not well understood or transparent, there may be multiple layers of side effects, with some that may prove to be extremely costly.<sup>9</sup>

U.S.-based MNCs often achieve double nontaxation through the dual goals of (1) avoiding taxation in the foreign countries where they operate or earn revenue and (2) avoiding U.S. taxation by side-stepping the subpart F anti-tax-haven controlled foreign corporation rules and choosing not to repatriate their accumulated earnings back to the United States. Sometimes an MNC's financial statement segment information will indicate that profits on its foreign operations are higher than those on its domestic operations for the same categories and levels of sales. Foreign-based MNCs use various mechanisms that work within their countries' CFC rules to strip assets and earnings out of countries (including the United States) in which they conduct operations while avoiding any home-country taxation of those earnings. The success of these efforts has had such a detrimental effect on government revenue worldwide that it sparked the political will among the G-20 nations to initiate the two-year OECD BEPS project.

Perhaps counterintuitively, in spite of the United States having probably the most sophisticated and complex tax laws of any developed nation, U.S. MNCs have aggressively turned the law on its head. They have done so partly through strong and

effective lobbying and partly through effective arbitrage of the inconsistent laws and treaty networks of the United States and other countries. All this has emboldened MNCs to implement tax avoidance strategies resulting in billions of dollars stockpiled in offshore jurisdictions offering zero or low taxation. One might draw the conclusion that complex tax laws seem to inspire bad tax behavior rather than restrict it.

In implementing their tax avoidance strategies, MNCs may make few if any meaningful changes to their business models or operations, they invest little or no money in locations where they purport to earn profits, and they create few if any new employment opportunities.<sup>10</sup> Typically, the goal is to make as few operational and personnel changes as possible in order to neither disturb the current business model nor incur additional costs. In this web of precision tax planning, it is fair to ask: Where is the economic substance, and what is the business purpose, other than to reduce income taxes on a scale previously unimagined? This planning stands in stark contrast to situations in which an MNC's management launches some new activity such as building a manufacturing or research and development facility, adopting an employee incentive plan, or purchasing or merging with another company. In these cases, the anticipated operational change or new investment is the impetus to consider the best tax structure.

What are some of the intragroup agreements and other contractual mechanisms used to justify profit-shifting structures? In brief, assets — especially unique, hard-to-value intellectual property — may be transferred at what an MNC asserts to be fair market value, but often that value is open to serious question. Loans and license agreements are used to route income from one country to another, creating large interest and royalty deductions in high-tax

<sup>6</sup>Richard Rubin, "U.S. Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes," Bloomberg Business, Mar. 4, 2015.

<sup>7</sup>See OECD, "Measuring and Monitoring BEPS, Action 11 — 2015 Final Report," at 15 (Oct. 5, 2015).

<sup>8</sup>A particularly blatant example of this may be found in the July 30, 2015, testimony of Howard Schiller, the now-former CFO of Valeant Pharmaceuticals International, in hearings before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI) (see *infra* note 10).

<sup>9</sup>Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," 221 J. Acct. 48 (Feb. 2016).

<sup>10</sup>Three examples are Caterpillar Inc., Microsoft Corp., and Valeant, all of which were investigated by the PSI (see *infra* note 11). For Caterpillar, the investigation found that its Swiss tax strategy was put in place with virtually no operational changes. See also *infra* text accompanying note 68. For Microsoft, the investigation noted that its Puerto Rican subsidiary, which was established after the elimination of section 936 benefits, continued (although in a new production facility) the same operations that were previously conducted under the section 936 scheme with the same personnel. Valeant is a Canadian company resulting from a 2010 inversion transaction. Quickly after completing several major U.S. acquisitions (*e.g.*, Bausch & Lomb (2013) and Salix Pharmaceuticals (2015)), Valeant transferred intellectual property into a foreign group member (a non-CFC) that would act as the entrepreneurial risk-taking party. In all three cases, newly executed intercompany contractual arrangements shifted significant income previously recognized by U.S. group members to foreign group members in low-tax jurisdictions.



countries, with the offsetting income being earned in zero- or low-tax countries. Service agreements provide the cover for group operating companies that employ the personnel who are actually responsible for much of the business conducted in the name of and for the benefit of the zero- or low-taxed group members. Tax treaties and favorable private tax rulings from countries such as Ireland, Luxembourg, and the Netherlands are additional tools used by MNCs to reduce their tax burdens.

Despite MNCs' apparent confidence in pursuing these profit-shifting strategies, there is a growing chorus of criticism from U.S. congressional hearings,<sup>11</sup> major newspapers, magazine articles, other media, and nongovernmental organization reports.<sup>12</sup> And the International Consortium of Investigative Journalists recently disclosed on its Luxembourg leaks webpage private tax rulings that granted special privileges to hundreds of MNCs.<sup>13</sup>

The SEC filings of some high-profile MNCs have reported IRS audits resulting in the assertion of billions of dollars in additional tax, interest, and penalties.<sup>14</sup> The amounts of additional tax asserted by the IRS are simply staggering, and perhaps if those sums were widely reported on the evening news, Americans across the country would demand to know what is going on. News reporting about Google's recent tax settlement in the United Kingdom caused considerable backlash among the U.K. public and politicians alike, and it has triggered hearings by the U.K. Parliament's Public Accounts

Committee demanding to know why the settlement was so small, even though it covered a decade of tax obligations.<sup>15</sup>

This report does not attempt to dissect the elaborate technical components of profit-shifting schemes, but it does speculate on why MNC managements and their advisers are such avid practitioners of them. Further, this report considers whether these parties may have crossed some ethical line in devising and implementing these schemes that are now largely viewed as a serious affront and challenge to the reasonable collection of taxes in many nations.

## B. Ethics — Payment of Taxes

Many MNCs hold themselves out as model corporate citizens and role models, sponsoring charity events, donating large sums of money to worthwhile causes, and giving back to the community in a variety of ways. Some of these MNCs are active in lobbying for a greener society, promoting health benefits, and providing opportunities for disadvantaged youth and others. For example, Tim Cook, CEO of Apple Inc., was highly praised when he responded in a firm, no-nonsense manner to some pointed questions at a February 2014 Apple shareholders' meeting. As reported by *The Mac Observer*:

The NCPPR [National Center for Public Policy Research] representative asked Mr. Cook to commit right then and there to doing only those things that were profitable.

What ensued was the only time I can recall seeing Tim Cook angry, and he categorically rejected the worldview behind the NCPPR's advocacy. He said that there are many things Apple does because they are right and just, and that a return on investment (ROI) was not the primary consideration on such issues.

"When we work on making our devices accessible by the blind," he said, "I don't consider the bloody ROI." He said the same thing about environmental issues, worker safety, and other areas where Apple is a leader.

As evidenced by the use of "bloody" in his response — the closest thing to public profanity I've ever seen from Mr. Cook — it was clear that he was quite angry. His body language changed, his face contracted, and he spoke in rapid fire sentences compared to the usual metered and controlled way he speaks.

<sup>11</sup>These congressional hearings include:

- House Ways and Means Committee, "Possible Income Shifting and Transfer Pricing" (July 22, 2010). See Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010) (includes disguised examples of profit-shifting structures used by U.S.-based MNCs);
- PSI, "Offshore Profit Shifting and the U.S. Tax Code — Part 1" (Sept. 20, 2012) (Microsoft and Hewlett-Packard);
- PSI, "Offshore Profit Shifting and the U.S. Tax Code — Part 2" (May 21, 2013) (Apple);
- PSI, "Caterpillar's Offshore Tax Strategy" (Apr. 1, 2014); and
- PSI, "Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs" (July 30, 2015).

<sup>12</sup>See, e.g., "Unhappy Meal: €1 Billion in Tax Avoidance on the Menu at McDonald's" (Feb. 24, 2015) (report by a coalition of European and American trade unions and a U.K.-based anti-poverty campaign group); and Americans for Tax Fairness, "The Walmart Web: How the World's Biggest Corporation Secretly Uses Tax Havens to Dodge Taxes" (June 2015).

<sup>13</sup>This database of documents is available at <http://www.icij.org/project/luxembourg-leaks>.

<sup>14</sup>See Forms 10-K for Caterpillar (year ending Dec. 31, 2014) and Microsoft (fiscal year ending June 30, 2015), and the Form 8-K dated September 18, 2015, for the Coca-Cola Co.

<sup>15</sup>See Phillip Inman, "Google Tax Deal Under Fire as It Emerges Figure Included Share Options Scheme," *TheGuardian.com* (Feb. 4, 2016); and House of Commons, Public Accounts Committee, "Corporate Tax Settlements" (Feb. 23, 2016).

He didn't stop there, however, as he looked directly at the NCPPR representative and said, "If you want me to do things only for ROI reasons, you should get out of this stock."<sup>16</sup>

This is a pretty powerful statement and, no doubt, was heartfelt. So yes, there is much good that can be said about many MNCs and their leaders.

But there is a darker side to this coin. While it is appropriate to admire these good works, it is also time to take a hard look at the actions and decisions of the management and professional advisers of MNCs to determine whether their tax behavior is doing no harm.<sup>17</sup> With this in mind, it is also appropriate to ask, or perhaps demand, why MNCs have failed to be more proactive in protecting both their stakeholders and society from the ills of the tax avoidance that they have so readily and enthusiastically embraced on a global scale.

There is a clear paradox here. In contrast to Cook's statement that Apple works hard to be socially responsible, the payment of taxes is simply not one of Apple's means for doing so. On a segment of CBS's *60 Minutes* that aired December 20, 2015, Charlie Rose observed that "Apple is engaged in a sophisticated scheme to pay little or no corporate taxes on . . . revenues held overseas," prompting Cook to respond somewhat heatedly: "That is total political crap. There is no truth behind it. Apple pays every tax dollar we owe." This makes about as much sense as an official of the Chicago Cubs bragging that the team hasn't lost a World Series in the last 70 years, with apologies to that great American sports team. What MNC representatives *don't* say is that the success of their profit-shifting strategies may too often depend on strained interpretations of the tax law, unintended benefits

<sup>16</sup>Bryan Chaffin, "Tim Cook Soundly Rejects Politics of the NCPPR, Suggests Group Sell Apple's Stock," *The Mac Observer* (Feb. 28, 2014).

<sup>17</sup>See Bret Wells, "Voluntary Compliance: 'This Return Might Be Correct But Probably Isn't,'" 29 *Va. Tax Rev.* 645, 692 (2010). Wells states:

Taxpayers and their tax advisors can claim tax benefits that they do not believe are sustainable without fear of penalty. Large taxpayers and sophisticated tax advisors have used this leniency to create significant underpayments with the hope that these positions will not be discovered on audit and even if discovered on audit can be settled for a partial victory. Far too many taxpayers employ a wait-and-see approach to issue resolution that creates a significant burden on the IRS and increases the ongoing tax gap at a time when the country needs to motivate its taxpayers to pay their taxes in full in a timely way. Current law requires the IRS to expend an ever-increasing level of audit effort to uncover complicated and difficult planning techniques that nobody believes will work but can provide substantial underpayments if not properly discovered on audit.

from both the law and tax treaties, inconsistent positions in different tax jurisdictions, hidden concessions from tax haven countries, and, in some cases, ignorance of how the company actually conducts its business. Some MNC managements have criticized the failings and unintended consequences of the IRC but then gone to great lengths to rationalize their profit-shifting activities as just ordinary and benign corporate planning that is fully consistent with the law.<sup>18</sup>

Given the conflicting behavior of MNCs, are the ethics of paying taxes simply a value judgment that may vary widely with the identity and values of the person considering it? Many MNC CEOs may believe that a part of their fiduciary duty to shareholders is to minimize taxes to the extent legally possible,<sup>19</sup> even though recent case law would suggest that no such duty exists.<sup>20</sup> However, many

<sup>18</sup>See, e.g., Philip Stephens, "Why Google and Eric Schmidt Really Don't Care About Tax," *FT.com* (May 29, 2013); Gwyn Topham, "Google's Eric Schmidt: Change British Law and We'd Pay More Tax," *TheGuardian.com* (May 26, 2013); and Charles Arthur, "Google Chairman Eric Schmidt Defends Tax Avoidance Policies," *TheGuardian.com* (Apr. 22, 2013).

<sup>19</sup>We note later the inherent conflict of interest when CEOs and other management personnel receive stock options, stock issued under performance share plans, and other equity-based compensation that gives them an incentive to minimize the MNC's tax expense and maximize share price.

<sup>20</sup>See Daniel Hemel, "A 'Duty' to Minimize Taxes?" *The University of Chicago Law School Faculty Blog* (Dec. 22, 2015). See also the cases Hemel cites, including *Freedman v. Adams*, 2012 Del. Ch. LEXIS 74 (2012); and *Seinfeld v. Slager*, 2012 Del. Ch. LEXIS 139 (2012). The courts in those two cases found no fiduciary duty to minimize taxes. The *Freedman* court stated:

For reasons that are both numerous and obvious, this Court is not convinced that it should endorse this proposed new duty. Tax strategy is a complex, dynamic area of corporate decision-making that affects and is affected by many other aspects of a company. A company's tax policy may be implicated in nearly every decision it makes, including decisions about its capital structure, the legal forms of the various entities that comprise the company, which jurisdictions to form these entities in, when to purchase capital goods, whether to rent or purchase real property, where to locate its operations, and so on. Minimizing taxes can also require large expenditures for legal and accounting services and may entail some level of legal risk. As such, decisions regarding a company's tax policy are not well-suited to after-the-fact review by courts and typify an area of corporate decision-making best left to management's business judgment, so long as it is exercised in an appropriate fashion. This Court rejects the notion that there is a broadly applicable fiduciary duty to minimize taxes. [Footnote omitted.]

See also Stephen Bainbridge, "Fiduciary Duties and Corporate Tax Avoidance," *ProfessorBainbridge.com* (Sept. 10, 2013).

Regarding a similar finding of a lack of any fiduciary duty to minimize tax in the United Kingdom, see Jolyon Maugham, "Do Companies Have a Duty to Avoid Taxes?" *Waiting for Godot blog* (Jan. 27, 2016).

other individuals — including politicians, economists, and the man on the street — recognize that corporate income tax is one of several taxation mechanisms meant to fund legitimate governmental and societal needs. They believe that all MNCs should appropriately contribute to those needs and that any effort to avoid doing so through, for example, profit-shifting structures that involve tax haven companies and seemingly artificial related-party transactions, is unethical. Sen. John McCain, R-Ariz., might be said to fall into this latter category.<sup>21</sup>

As a byproduct of some profit-shifting schemes, disgruntled former employees have leveled charges of inappropriate behavior at employers from which they separated after reporting what they believed to be questionable or illegal tax structuring. There are cases against Caterpillar and Viacom, for example.<sup>22</sup> The former case inspired hearings by the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations in 2014, and those hearings were apparently a factor in the IRS's January 2015 assertion of significant tax adjustments to Caterpillar's income. Caterpillar is disputing those adjustments. See Section IV.A.

It is fair to say that profit-shifting structures rarely, if ever, reflect shoddy technical analyses, but it is also reasonable to speculate that the underlying research and structures are sometimes formulated with an eye on the end result, which perhaps biases the research. Moreover, it is likely that in many cases these analyses either consciously or unconsciously are done without acknowledging the MNC's full factual situation, which means that difficult facts are rationalized away. Despite these generally careful technical analyses, the final planning may too often be void of any ethical considerations concerning the circumvention of clear congressional intent or the lack of substance or

valid business purpose other than avoiding tax. Rather, fragile rationales are justified by the desired end result. The very complexity and overly technical nature of U.S. tax law may actually be a godsend for MNCs' managements and their advisers, perhaps in some cases giving them cover for failing to conscientiously fulfill their ethical obligations to employers, stakeholders, and society at large.

### III. Ethical Benchmarks

#### A. An Approach to Span the Ethical Divide

As is so often true in other areas, there are opposing views on what constitutes acceptable behavior in the payment of tax. Clearly, some MNCs believe that tax obligations should be minimized and that any method with a veneer of legal backing is acceptable. Other MNCs and many stakeholders think that every company has a responsibility to pay its fair share of taxes as a means of funding the governments of the countries in which the MNC operates or earns revenue.<sup>23</sup>

Considering the above and the importance of these matters to the well-being of society, is it possible to somehow make sense of these diametrically opposed reactions to taxation? Is there any chance at all for reasonable people who are not tax experts to reach some common ground on what is ethical when it comes to paying taxes, at least for MNCs?

Perhaps as a first step, an objective approach is needed to encourage the board members and management of an MNC, most or all of whom are not tax experts, to evaluate the company's taxpaying behavior. Using this approach may satisfy the board and management that all significant tax planning complies with both the spirit and language of the law, thus allowing the MNC to claim the moral high ground in facing any questions about its tax structures. In other cases, the analysis may demonstrate that the profit-shifting structures implemented by an MNC fall short and do not meet any bar of

<sup>21</sup>In his opening statement at the 2013 PSI hearings on Apple, McCain stated:

As the shadow of sequestration encroaches on hard-working American families, it is unacceptable that corporations like Apple are able to exploit tax loopholes to avoid paying billions in taxes. . . . It is completely outrageous that Apple has not only dodged full payment of U.S. taxes, but it has managed to evade paying taxes around the world through its convoluted and pernicious strategies. . . . It is past time for American corporations like Apple to reorganize their tax strategies, to pay what they should, and invest again in the American economy.

See *supra* note 11.

<sup>22</sup>Regarding Caterpillar, see PSI, "Caterpillar's Offshore Tax Strategy, Majority Staff Report," at 3; and *Schlicksup v. Caterpillar Inc.*, No. 09-1208 (C.D. Ill. filed 2009). For Viacom, see *Williams v. Viacom International Media Networks Inc.*, No. 1:16-cv-00029 (S.D.N.Y. filed 2016). Aspects of these two MNCs' situations are discussed later herein.

<sup>23</sup>See Doron Narotzki, "Corporate Social Responsibility and Taxation: An Evolving Theory," *Tax Notes*, Jan. 25, 2016, p. 455. Narotzki comments:

This article doesn't address whether corporations should pay taxes; rather it argues that the new direction, not only from society's and the state's standpoint but also — perhaps most surprisingly — from the corporate standpoint, is that corporations carry a responsibility to pay corporate tax and help others "carry the burden." The development of this idea spawns from the concept of corporate social responsibility theory, more commonly known as CSR. [Footnote omitted.]

He also says, "The OECD was on the right track to solve the issue of harmful tax competition, but focusing instead on encouraging companies to act voluntarily to please the public may be a more efficient way to achieve results."



ethical tax behavior, suggesting that these structures should be changed or unwound.

Three well-known MNCs now face IRS efforts to reverse a portion or all of their profit-shifting structures,<sup>24</sup> and in each case, the IRS appears to have based its adjustments in part on the application of transfer pricing rules or the judicial doctrines briefly noted earlier. Given the subjectivity of these tools, success for either side is uncertain. Moreover, the judicial doctrines have not provided any bright-line tests for taxpayers or the IRS to follow. In contrast, the approach described below, which is statutorily based and more objective in its application, takes some of its inspiration from the *Gregory* decision, which clearly expressed the need for consistency between the taxpayer's actions and the intent of the underlying statute.<sup>25</sup>

The IRC is the principal vehicle through which Congress has defined tax policy and provided the rules for the United States to collect income tax to meet governmental and societal needs. Although the code is voluminous, complex, difficult to decipher, and all too often exhibits opposing tax policy goals, one can identify some fundamental principles and congressional intent. Moreover, an understanding of these principles and congressional intent may allow all parties to better judge whether an MNC's management and professional advisers have sailed too close to an ethical edge in implementing the company's profit-shifting tax strategies.

What are these principles?

There can be no question that Congress intended corporate groups to have the freedom to own property, employ personnel, and conduct their operations through U.S. companies, foreign companies, or both. It is also a basic principle of the U.S. tax system that with few exceptions, each domestic and foreign group member of an MNC will be respected as a separate legal person with full rights to the income it earns from the business and activities that it carries out through its employees and agents. A further bedrock principle of U.S. tax law is that the worldwide income or loss of a U.S. company is includable in its U.S. tax base, but the rules for the taxation of foreign income by the United States vary depending on the fact pattern.

For example, if an MNC chooses to conduct some portion of its operations within a foreign group member, congressional intent and the underlying principles for determining what foreign income is currently taxed or should remain untaxed by the United States (at least until repatriation for any

foreign group member ultimately owned by U.S. persons) may be discerned by examining mechanisms in specific code sections, IRS regulations, and judicial decisions. These mechanisms, which cover important aspects of international tax structuring, including the current taxation or deferral of foreign income, were enacted to rein in improper tax behavior and encourage a high level of compliance by all taxpayers. With these principles and congressional intent as a guide, an MNC's factual situation and payment of tax may be examined to determine if its behavior is consistent with or diverges from them.

The mechanisms relevant to MNC international tax structuring, which are set out in appendices A through E, include:

- the subpart F CFC rules;
- the check-the-box entity classification rules;
- the effectively connected income rules;
- transfer pricing rules; and
- judicial doctrines.

#### B. Recommended Approach — Testing for ECI

MNC international tax planning generally and profit-shifting structures in particular typically involve establishing group companies in zero- or low-taxed jurisdictions that conduct transactions with customers and other third parties that can be accomplished only through crucial support provided by other group members under intragroup agreements. For a CFC, its earnings are not subject to any U.S. taxation until repatriated (or deemed repatriated) as dividends or in some other manner.<sup>26</sup> With the growing amount of untaxed foreign earnings held by CFCs now reportedly topping \$2 trillion,<sup>27</sup> it is fair to observe that few U.S. MNCs are in any hurry to repatriate their earnings. Cook emphasized this point in his appearance on the December 20, 2015, *60 Minutes* program when he said, in response to Rose's question of why Apple didn't bring its money home: "Because it would cost me 40 percent to bring it home. And I don't think that's a reasonable thing to do."

Appendices A through E discuss issues, principles, and when relevant, congressional intent for specific mechanisms important to international tax structuring and that can tax income of foreign group companies.

The ECI rules (Appendix C) are relatively objective once an MNC's factual situation is fully

<sup>24</sup>See *supra* note 14.

<sup>25</sup>See *Gregory*, 293 U.S. at 470.

<sup>26</sup>Consistent with actual group structures, it is assumed that U.S. MNCs have arranged their structures to sidestep any section 951(a)(1)(A) income inclusions.

<sup>27</sup>See Rubin, *supra* note 6.

known.<sup>28</sup> The application of the transfer pricing rules (Appendix D) and broad judicial doctrines (Appendix E) can be very subjective, even with a full understanding of an MNC's factual situation. The subpart F and CFC rules (Appendix A), while objective, are typically irrelevant since most MNCs can design their profit-shifting structures to fall outside their coverage. As explained in Appendix A, this was made easier following a 2006 change adopted by Congress effectively approving earnings stripping structures that transfer profits from countries in which foreign group members operate to related group members located in other countries, most often zero- and low-tax jurisdictions.

With subpart F being effectively toothless and the transfer pricing and judicial doctrines being subjective, the approach suggested here focuses squarely on the application of the ECI provisions to specific situations. The use of this benchmark requires an examination of an MNC's zero- or low-taxed foreign group members regarding the following three factors:

- identification and location of critical value drivers;
- location of actual control and decision-making of the foreign group member's business and operations; and
- the existence or lack of capable offshore management personnel and a CEO located at an office of the foreign group member outside the United States who actually manages the entity's entire business.

This examination of an MNC's business operation ignores arcane tax rules and allows directors and senior executives to focus objectively on and understand the value drivers, management, and business activities that produce the profitability of the group's zero- or low-taxed foreign members. All those persons should be able to determine whether their group's foreign members are recording income that is economically earned by them or is instead earned through value drivers, management, and activities conducted in the United States. When the latter is the case, both congressional intent and

<sup>28</sup>Many tax professionals may respond that the threshold determination for application of the ECI rules — that a foreign corporation has a trade or business in the United States — is itself subjective. Although it is true that there is no statutory definition for the existence of a trade or business in the United States, the fact pattern in many profit-shifting structures will make it clear that one exists and that any argument to the contrary will be frivolous at best. For detailed coverage of this issue, see Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, p. 193, at 196; and Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *Tax Notes*, Apr. 18, 2016, p. 335. See also *supra* note 9.

the relevant code sections are clear. That income is defined as ECI and is currently taxable by the United States.

When an examination of an MNC's situation shows that all or a portion of a foreign group member's income is currently taxable as ECI but that member has failed to file a U.S. tax return and pay tax, the member is acting contrary to congressional intent and the law.<sup>29</sup> Many MNCs may find themselves in this position.

Politicians, academics, tax campaigners, and other interested parties point to the low effective tax rates of some MNCs and cite the number of tax haven countries used.<sup>30</sup> However, these parties normally lack access to the confidential internal group information necessary to assess independently the above three factors and come to an informed opinion on whether an MNC's foreign group members have ECI. This means that these parties can point fingers at an imagined wrong but that they do so with no ability to establish whether an MNC has inappropriately avoided U.S. tax. This finger-pointing results in bad publicity for many MNCs,<sup>31</sup> whether warranted or not.<sup>32</sup>

Given the broad outcry against profit shifting, the high risks associated with these structures, and

<sup>29</sup>It is likely that few, if any, MNCs have reported and paid tax on the ECI of their zero- and low-taxed foreign group members. Some may have filed tax returns showing little or zero ECI protectively to start the running of the statute of limitations and to ensure the availability of deductions and credits. (See sections 6501(c)(3) and 882(c)(2).) This lack of voluntary tax compliance may be the result of ignorance of the tax law or the carelessness or inattention of professional advisers. Aggressive tax behavior, especially in this ECI area or in transfer pricing matters, may also be a side effect of conflicts of interest. See Section IV.

<sup>30</sup>See, e.g., Robert McIntyre, Richard Phillips, and Phineas Baxandall, "Offshore Shell Games 2015: The Use of Offshore Tax Havens by Fortune 500 Companies," U.S. Public Interest Research Group Education Fund and Citizens for Tax Justice (Oct. 2015).

<sup>31</sup>In "Why Public Country-by-Country Public Reporting for Large Multinationals Is a Must" (Feb. 24, 2016), a piece released by several civil society organizations, it was noted: "Debates on corporate tax liabilities, payments and avoidance often revolve around speculation and qualified guesses as things stand. This neither serves the interest of business nor the general public."

<sup>32</sup>There are also calls for generally unavailable internal tax structuring information to be made public. See Edward Kleimbar, "International Tax Reform Begins at Home," at 14 (Feb. 24, 2016) (written testimony prepared for the Ways and Means Committee hearing entitled "The Global Tax Environment in 2016"):

Companies do not have a legitimate claim that stateless income tax planning techniques used to drive down tax rates to single digits somehow constitute protected proprietary information, akin to the formula for Coca Cola. Phrased differently, it is incongruous that firms routinely state that they comply with all local laws, and that their

(Footnote continued on next page.)

the potential damage to an MNC's reputation, an MNC should welcome this objective ECI approach as a way to realistically assess its tax risks and establish its good corporate tax citizenship. This approach should be used internally and, if helpful, externally as well:

- Internally: This approach gives the board members and executive management who have little tax knowledge a simple framework within which to understand factually whether an MNC's profit-shifting structures comport with reality or depart from it, and to conclude whether those tax structures are ultimately in the best interest of the MNC.
- Externally: An MNC may use this approach to respond to critics' accusations of inappropriate or unethical tax behavior or merely to demonstrate good corporate citizenship. It may do this by presenting a factual summary to the public showing how each of its zero- or low-taxed foreign group members earns its income independently of U.S. group members through its own value drivers, management, and activities.

An MNC's board and senior management may realize that the profitability of some or all of its zero- or low-taxed foreign group members does in fact arise from value drivers, management, and business activity conducted in the United States. In that case, they have two choices. First, if they decide that the tax benefits are sufficiently important, they could make necessary operational changes to correct any problematic tax structures, accepting that doing so may result in additional operating costs, a potential duplication of functions, and other disruptions to their business model. Those operational changes could involve relocating personnel and substantive operational functions from the United States to offices of related foreign group members located outside the United States. Alternatively, the board and senior management may decide that the financial and reputational risks to the MNC are too great and thus conclude that the most prudent course is to unwind the offending structures. Regardless of which choice is made, attention will have to be given to paying taxes that may be due for prior years, as well as the possible effects on financial statement disclosures.<sup>33</sup>

If an MNC has been targeted by critics who allege that it uses inappropriate tax structures, it

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tax planning is entirely above board, but then are unwilling for that tax planning to be transparent to overwhelmed tax administrators in the many countries in which those firms do business.

<sup>33</sup>See *supra* note 9.

may decide to proactively defend itself using an ECI analysis to demonstrate its good corporate citizenship. Many MNCs recognize that the views of their customers and other stakeholders matter and that a reputation tarnished by not paying taxes can have detrimental business effects. Starbucks Corp. certainly experienced this in the United Kingdom,<sup>34</sup> and Walgreens Co., in choosing not to pursue an inversion transaction in 2014, cited negative public reaction as a factor.<sup>35</sup>

An MNC's effort to prove to critics that it is a good tax citizen in today's environment will be accepted only if the supporting information is made public and is verifiable by independent persons. Full transparency is an absolute necessity; the storm of bad publicity surrounding Google Inc.'s opaque settlement in January 2016 for avoiding U.K. tax clearly demonstrates this.<sup>36</sup> An MNC's failure to provide complete and verifiable information would send a strong signal that its conduct might not pass muster.

When an MNC chooses to take proactive steps to make public relevant factual information and show how the information supports its tax structure, academics and NGOs would likely be the independent persons with the expertise and motivation to analyze and comment on that information. Tax structures that are consistent with relevant principles and congressional intent and are supported

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<sup>34</sup>Allison Christians, "How Starbucks Lost Its Social License — And Paid € 20 Million to Get It Back," *Tax Notes Int'l*, Aug. 12, 2013, p. 637. Christians comments:

But the Starbucks story, along with a growing list of stories about public anger regarding apparent low- and nil-tax outcomes enjoyed by many multinationals, suggests that the social license to operate has expanded beyond labor and environmental issues, and beyond poor countries. A company's social license may now encompass transnational community standards on what fairness in taxation requires. Nonbusiness and nongovernmental individuals and organizations throughout the world have identified themselves as stakeholders with interests in the behavior of multinational corporations. These stakeholders have explicitly connected the low taxes paid by multinationals with the erosion of social services in poor and rich countries alike, and they are using various forms of social protest to articulate their own standards for fairness in taxation. In Starbucks's case, activists have in effect added a beyond-legal-compliance tax requirement to ensure the company's continued social license to operate in the U.K.

<sup>35</sup>See Walgreens press release (Aug. 6, 2014), noting: "The company also was mindful of the ongoing public reaction to a potential inversion and Walgreens' unique role as an iconic American consumer retail company with a major portion of its revenues derived from government-funded reimbursement programs."

<sup>36</sup>See Stephanie Soong Johnston, "Google Deal Not a 'Glorious Moment,' U.K. Official Says," *Tax Notes Int'l*, Feb. 8, 2016, p. 477.



by verifiable facts should generate favorable reports and an improved reputation for the MNC.

MNCs that have implemented profit-shifting structures but have made few changes in the actual conduct of their business operations<sup>37</sup> should be among the first to want to apply this ECI approach internally.

Regardless of what MNCs choose to do either internally or externally, outside auditors must independently examine the factual situations for possible ECI for each of their MNC clients. That step should be a prerequisite for an auditor to issue an opinion on a client's financial statements. Although auditors will, of course, already have access to extensive country-by-country (CbC) and group member information on employees, assets, etc., the CbC reporting expected to be mandated by many home countries of MNCs will put some of this information into a more accessible form, which might be a useful tool for the auditors.<sup>38</sup>

For the purpose of applying the benchmark using the ECI rules, an MNC's transfer pricing, intercompany agreements, and corporate structures are accepted "as is," despite the subjectivity of the transfer pricing rules and the judicial doctrines by which the tax legitimacy of those structures could be challenged or recharacterized. This acceptance of the MNC's profit-shifting structure "as is" would both simplify the application of the benchmark and recognize that MNCs have generally maximized income in their zero- or low-taxed foreign group members, with the hope that this result would be sustained if examined by the IRS. There is precedent indicating that a taxpayer must accept the adverse consequences of whatever corporate and contractual structures it has created.<sup>39</sup> When the ECI rules apply and some or all of a foreign group member's income is taxable at rates exceeding 35 percent, that MNC has improperly transferred income to its foreign group members and may be subject to back taxes, penalties, and interest.

<sup>37</sup>See *supra* note 10.

<sup>38</sup>Regardless of whether MNCs decide to use the suggested ethical benchmark externally, they should consider making public their CbC reports. Although the OECD BEPS action 13 final report (Oct. 5, 2015) and the proposed U.S. regulations implementing CbC reporting (REG-109822-15) both require confidentiality, political and public pressure for CbC reporting to be made public is mounting. MNCs that voluntarily make their own reports public will have taken another step to demonstrate their good tax citizenship.

<sup>39</sup>For a brief discussion of this area, see JCT, "Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)," JCS-3-99, at 185 (July 22, 1999).

### Appendix A: Subpart F CFC Rules

These rules specify categories of income that when earned by a CFC, cause current taxable income to its U.S. shareholders.<sup>40</sup> Subpart F income categories include some passive income (dividends, interest, royalties, rentals, gains, etc.) and some sales and services income involving related parties and physical locations outside the CFC's country of incorporation.

Congress's intent in enacting the subpart F rules in 1962 was to severely limit the ability of MNC's to shift profits into CFCs established in zero- or low-taxed countries. The guiding principle of this legislation was that deferral should be allowed only when there is real business activity conducted in the CFC's country of incorporation or when a purchase, sale, or service is factually connected with that country.

As enacted, congressional intent was broad and covered profit shifting no matter whether U.S. taxes or foreign taxes were being avoided. The House report stated the following in connection with some sales structures:

Your committee also has ended tax deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to siphon off sales profits from goods manufactured by related parties either in the United States or abroad. In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.<sup>41</sup> [Emphases added.]

Despite this original broad intent, more recent congressional action has effectively approved tax structures that avoid foreign taxes.<sup>42</sup> This position was included in a 2006 amendment and supported by a House report:

Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the

<sup>40</sup>A CFC is a foreign corporation of which more than 50 percent of its voting power or value is owned directly or indirectly by U.S. shareholders. A U.S. shareholder generally includes any U.S. person that directly or indirectly owns 10 percent or more of the CFC.

<sup>41</sup>H. Rep. No. 87-1447, at 58 (1962).

<sup>42</sup>The related CFC look-through rule of section 954(c)(6) was recently extended through 2019 by section 144 of the Protecting Americans From Tax Hikes (PATH) Act of 2015, P.L. 114-113.



immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.<sup>43</sup>

Essentially, then, the principle is that from 2006 onward, any structure intended to avoid only foreign tax through payments of interest and royalties from an active business that itself does not create subpart F income is acceptable and reflects congressional intent. The message to U.S. MNCs is clear: Qualifying earnings stripping payments out of a related CFC are sanctioned by Congress.<sup>44</sup>

### Appendix B: Check-the-Box Rules

In a simplification move, Treasury and the IRS, acting within their regulatory authority, implemented rules that allow taxpayers to simply choose the tax classification (taxable or transparent entity) they desire for some organizations. Before this change, entity classification was determined based on an examination of the characteristics of the organization. When this rule was adopted, Treasury and the IRS recognized that a risk of this simplification in the foreign area was an encouragement of hybrid entities, with possible detrimental effects.<sup>45</sup>

Shortly after these new rules went into effect in 1997, some of those detrimental effects swiftly arose. Treasury and the IRS attempted to counter them but were effectively beaten back through MNC lobbying and some support in the Senate.<sup>46</sup> The result has been that the check-the-box rules allow the use of hybrid entities as important components of tax avoidance structures to both avoid the subpart F rules and shift profits out of countries

<sup>43</sup>H. Rep. No. 109-304, at 45 (2005).

<sup>44</sup>The tax extenders enacted by Congress in December 2015 (through the PATH Act) renewed this provision through 2019. Recent congressional hearings included comments not supportive of G-20 and OECD BEPS goals that seek to restrain MNCs in their profit-shifting behavior through both individual country and multilateral actions. See "Hatch Statement at Finance Hearing on OECD BEPS Reports" (Dec. 1, 2015), in which Finance Committee Chair Orrin G. Hatch, R-Utah, commented: "While international efforts to align tax systems are worth exploring, we shouldn't be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States — our own economy, our own workers, and our own job creators — should be our sole focus."

<sup>45</sup>See Notice 95-14, 1995-14 C.B. 297; and T.D. 8697.

<sup>46</sup>See David L. Click, "Treasury Withdraws Extraordinary Check-the-Box Regulations," *Tax Notes*, Oct. 6, 2003, p. 95. Click's article provides some history of these efforts by Treasury and the IRS, the reactions to them, and the actions taken in the Senate.

where actual operations are conducted. In a 2000 study, Treasury's Office of Tax Policy commented:

The availability of tax avoidance techniques involving hybrids did not originate with the check-the-box regulations. However, the check-the-box regulations exacerbated the problem in three significant ways. First, they eliminated the uncertainty associated with applying the four-factor [entity characterization] test [that had applied previously]. This reduced the costs and risks associated with hybrid arrangements and thus greatly facilitated their use. Second, they focused attention on the use of hybrid arrangements. The result was a considerable increase in design and marketing efforts among tax planners that introduced hybrid planning techniques to mainstream taxpayers. Finally, and perhaps most importantly, the check-the-box regulations facilitated the formation of a new type of entity (or non-entity): an entity "disregarded as an entity separate from its owner" (often referred to as a "disregarded entity"). It is the disregarded entity that features prominently in a number of significant subpart F tax planning techniques.<sup>47</sup> [Citations omitted.]

The relatively black-and-white mechanical nature of the subpart F rules and the care with which profit-shifting structures have been designed to fall outside their coverage have clearly watered down the effectiveness of the subpart F rules as originally enacted.

A major goal of many structures initiated after the new entity classification rules, which made the creation of hybrid entities relatively simple, is to siphon profits out of high-tax countries. It was noted in Appendix A that the 1962 congressional intent of the subpart F rules was to prevent this. Thus, the check-the-box rules created by Treasury and the IRS facilitated something that was clearly the opposite of congressional intent.

While this conflict continued through 2005, the 2006 change to subpart F (the CFC look-through rule) effectively condoned the use of hybrid entities for siphoning income into zero- and low-taxed CFCs from the countries where related CFCs operate. Accordingly, since 2006, no matter how problematic that result might be to the many foreign countries on the receiving end, this type of profit-shifting structure (for example, the use of hybrid entities to structure intragroup payments that fall

<sup>47</sup>Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," at 69 (Dec. 2000).

outside the coverage of subpart F and are deductible expenses in the countries where operations occur) is consistent with congressional intent.

MNC tax planning may be consistent with the tax principles and congressional intent behind the subpart F and check-the-box mechanisms, but the other mechanisms listed below in appendices C through E may still apply depending on the facts and circumstances.

### Appendix C: ECI Rules

In general, the code imposes direct corporate tax on any foreign corporation, including a CFC, that conducts business in the United States and earns specified types of income through that U.S. business. A foreign corporation can conduct that business in the United States through its own employees, the activities of its agents, or the activities of a partnership of which it is a partner.

Application of the ECI rules requires an in-depth review of the actual activities of a foreign corporation (foreign group member) as well as how the actions taken by its related U.S.-based group members support the foreign group member's business. Only in this manner can it be determined whether a foreign group member is conducting a trade or business in the United States and has ECI.

An ECI review requires considerable time and effort. It starts with a review of all available documentation and includes comprehensive interviews of the group's operating personnel. Interviews are critical, since much necessary factual information may not be in available documentation. Moreover, it is doubtful that an MNC's in-house tax department or its advisers would have performed a systematic and objective ECI review in researching and implementing a profit-shifting strategy. Further, these types of reviews are normally beyond the scope of work performed by an MNC's outside audit firm other than perhaps some cursory audit checklist questions. The expectation here is that MNCs and their professional advisers in researching and implementing profit-shifting structures have given short shrift to whether the structures implemented might create ECI for any group member.

If a foreign corporation conducts a trade or business in the United States, any ECI of the foreign member will be directly taxable by the United States at effective tax rates of up to 54.5 percent or higher.<sup>48</sup> This effective tax rate is considerably higher than the normal 35 percent U.S. corporate tax rate.

<sup>48</sup>Kadet, *supra* note 28, at 195. Note that if a tax treaty applies, this 54.5 percent will be lower but will still be above the normal 35 percent U.S. corporate tax rate.

Clearly, few foreign group members that are part of a profit-shifting structure will have their own employees regularly working within the United States in a manner that would create a U.S. trade or business. However, many profit-shifting structures involve extensive joint business activities by both the foreign group member and at least one U.S. group member, or extensive activities in the United States conducted by U.S. group members on the foreign group member's behalf, often through inter-company service agreements. Either situation can cause a foreign group member to be engaged in a trade or business in the United States and thus earn ECI.<sup>49</sup>

Situations that could result in a trade or business in the United States and ECI include those that involve three factors<sup>50</sup>:

- critical value drivers performed predominantly by U.S. group members;
- extensive U.S.-located control and decision-making that far exceed what would be found in typical unrelated-party situations; and
- a lack of capable offshore management personnel and no CEO of the foreign group member who in substance runs its entire business.

These three factors reflect that it is often U.S.-based human and financial capital of a U.S. group member and the legal and physical infrastructure within the United States that play such important roles in the success of both the MNC's U.S.-based businesses and the portion of those businesses conducted in the name of zero- and low-taxed foreign group members.

Detailed descriptions in various publicly available sources create a reasonable belief that many MNCs have key business units that are managed either wholly or partly within the United States, with U.S. personnel conducting significant business functions on behalf of zero- or low-taxed foreign group members.<sup>51</sup> Despite this, these same public sources report that a significantly disproportionate

<sup>49</sup>When there are joint business activities, they may be sufficient to create a partnership for U.S. tax purposes under the broad rules of reg. section 301.7701-1 and -3, which include coverage of contractual arrangements. Even when there are no joint business activities, profit-shifting structures often involve U.S. group members, under the cover of a service or similar agreement, conducting activities and making day-to-day business decisions for the foreign group member that far exceed what any normal service provider would do or what any shareholder would do in its shareholder capacity. If those activities amount to an agency relationship, the U.S. group member is conducting the business of the foreign group member. See Kadet and Koontz, *supra* note 28.

<sup>50</sup>*Id.* at 196.

<sup>51</sup>See, e.g., information provided in connection with several PSI hearings. See *supra* note 11.

level of income from those businesses is contractually routed to foreign group members that treat none of that income as ECI subject to U.S. tax. In such cases, the factual situations will likely be so obvious that no objective analysis could reasonably suggest that there is not at least some ECI taxable in the United States.

Congressional intent for the U.S. taxation of income earned by a foreign corporation is clear. Foreign corporations are not subject to tax on income that is derived from the active conduct of business outside the United States. This includes foreign corporations that are CFCs. Full deferral of U.S. tax is permitted until profits are repatriated to U.S. shareholders or until some other realization event occurs. However, when the business of any foreign group member is actually managed and conducted in any material respect by the personnel and facilities of U.S. group members that are acting as agents or proxies, the congressional intent is to currently tax the relevant profits earned by that foreign group member.<sup>52</sup> When an MNC has structured any foreign group member to recognize income in this manner and has not arranged for it to voluntarily file U.S. tax returns and pay U.S. tax, that MNC's structure does not comply with the tax law.

#### Appendix D: Transfer Pricing Rules

Despite the common reality today that many MNCs operate as centrally managed unitary businesses, tax systems worldwide respect the principle

<sup>52</sup>See S. Rep. No. 89-1707, at 18 (1966). In connection with the enactment of the Foreign Investors Tax Act of 1966, P.L. 89-809, the Finance Committee stated:

Your committee agrees with the House that foreign corporations carrying on substantial activities in the United States, in such cases, should not be able to cast their transactions in such a form as to avoid both all U.S. tax and most foreign taxes. Also, it is believed that foreign corporations should pay a U.S. tax on the income generated from U.S. business activities. There appears to be no national policy to be served by allowing foreign persons to operate in this country without paying their share of our governmental expenses.

that each group member is a separate legal entity. As a separate legal entity, each group member is an independent taxpayer earning income and paying tax on that income.

Often, MNC group members have significant intercompany transactions that may include intra-group sales, services, loans, and licenses. Under applicable transfer pricing rules, the price levels, service charges, interest rates, royalty rates, etc. must be set at arm's-length levels.

Here again, congressional intent is clear. Intercompany transactions must be arranged to satisfy the arm's-length standard. However, except perhaps when there has been a gross departure from the arm's-length standard, the subjective nature of this standard means that it is normally not feasible to conduct the type of analysis that will determine whether an MNC's behavior is consistent with congressional intent, even though the code and regulations include extensive rules and examples to demonstrate acceptable methods of determining an arm's-length price. This is especially true for many sales and licenses of unique intangible assets that are often involved in profit-shifting structures.

#### Appendix E: Judicial Doctrines

Courts have long examined the contracts and conduct of taxpayers to decide whether to respect the form of their contracts and organization or to recharacterize what has occurred and apply the tax rules to the recharacterized "reality."<sup>53</sup> Although this has been an important mechanism in the enforcement of the U.S. tax law, its application is subjective and makes it difficult to determine whether an MNC's behavior is consistent with taxation principles as articulated by the courts. ■

<sup>53</sup>A recent example is Caterpillar Inc., for which the IRS in January 2015 issued a revenue agents report that seeks to tax the U.S. parent company on some income from the sale of spare parts booked by a Swiss subsidiary. Caterpillar disclosed in SEC filings that the IRS basis for its adjustment was "substance-over-form" or "assignment-of-income." See Form 10-K for Caterpillar, at 94-95 (year ended Dec. 31, 2015).