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Chairman Levin, Ranking Member Camp and members of the Committee, thank you for the opportunity to testify on the important topic of transfer pricing. I will focus my testimony today on Treasury's analysis of the available data relating to the issue of whether profits are being shifted abroad out of the United States for tax purposes through the mechanism of related party transactions or, as the mechanism is more commonly known in the tax policy community, through transfer pricing.

We conclude, based on our analysis of available data, that there is evidence of substantial income shifting through transfer pricing. In response, the Administration's FY 2011 Budget includes proposals that would reduce the incentive to transfer U.S. intangibles offshore to related parties, which is one of the transfer pricing techniques used to shift income out of the United States. In addition, the Treasury Department and Internal Revenue Service have undertaken a series of actions, including updating regulations, focusing enforcement capabilities and working with other countries, to improve the administration and enforcement of transfer pricing rules.

My testimony will provide some context regarding transfer pricing and the empirical evidence used in our analysis. I will describe Treasury's analysis of the available evidence and how it leads to a finding that there is substantial income shifting through transfer pricing. I then will briefly describe actions the Treasury and IRS have taken to address inappropriate income shifting.

Transfer Pricing In the Context of U.S. International Tax Rules

Before reviewing the empirical evidence, it is important to understand transfer pricing issue and its place in our international tax rules. Transfer pricing generally refers to the prices one affiliate in a corporate group charges another affiliate for the full range of intercompany transactions, including sales or licenses of property, the performance of services and transfers of intangibles. Where the affiliates are in different countries, there is the ability to shift income between the two countries involved in the transaction. More specifically, in such transactions the potential exists for tax-motivated transfer pricing abuse pursuant to which a multinational taxpayer may benefit by shifting income from the United States into a lower-tax foreign country.

There is a widespread international consensus, achieved over many years with the United States playing a leadership role, that the so-called arm's-length standard should be applied to police transfer pricing and prevent abuse. The implementation of the arm's-length standard has evolved over this period, with international support, to meet the challenges presented by our dynamic global economy. The Administration's FY 2011 Budget proposals regarding transfer pricing are fully consistent with the arm's length standard and are part of our continuing efforts to improve the administration and enforcement of our international tax rules.

Transfer pricing is one part of our overall international tax rules. The Administration's FY 2011 Budget contained several international taxation proposals, including proposals relating to transfer pricing, that seek to level the playing field by reducing the incentives in our current system to invest abroad and by closing loopholes that encourage shifting income to low-tax countries.

The Evidence

Before reviewing the empirical evidence, it is important to put the available evidence in a proper context. I also want to provide perspective on how we have weighed this evidence in undertaking recent regulatory projects and developing legislative proposals relating to transfer pricing.

The evidence from aggregate data is necessarily indirect – one may infer that transfer pricing abuse is likely the source of apparent anomalies in cross-border profit comparisons. Direct evidence, on the other hand, derives solely from careful examination of specific intercompany transfer pricing transactions by specific taxpayers in specific circumstances.

Whether and the extent to which there may be inappropriate income shifting from intercompany transactions in individual cases can only be definitively determined by examination of particular transactions, rather than at the more aggregated level that is the basis for the empirical economic analyses. In addition, transfer pricing transactional detail may be "buried" within the aggregated data. Accordingly, one must be cautious about drawing conclusive inferences from aggregated data about individual taxpayer activity.

The Administration has recently undertaken a number of transfer pricing regulatory efforts and in addition made legislative proposals, in both cases informed by direct evidence from the IRS's administration of the transfer pricing rules and supplemented by our evaluation of the indirect empirical evidence. Based on our evaluation of all of the evidence, we believe that there is evidence of substantial income shifting through transfer pricing. We also believe that income shifting through transfer pricing can best be addressed through specific remedies that are consistent with application of the arm's length standard.

It is important to distinguish between the different types of data that inform the evaluation of income shifting.[1] These data differ depending upon whether they are aggregated or company-level and, if company-level, whether they are based primarily on public financial reports or corporate income tax returns. In general, the more aggregated the data source, the less direct an inference can be made on the specific role of transfer pricing in explaining the data relationship or trends. Specifically, the data I will be discussing can be broken down into three categories:

1. Aggregated, country or region-specific data, such as tables published, for example, by the Bureau of Economic Analysis ("BEA data"), or summary tables of tax return data published by the IRS;

2. Company-level data based on non-tax public filings of publicly traded companies ("non tax-based company data"); and

3. Company-level and foreign subsidiary-level data based on tax and non-tax filings of U.S.-based multinational and their controlled foreign corporations ("tax-based company data").

The Treasury Department has access to proprietary tax return data, and so our efforts have tended to focus on the third category, tax-based company data, which we believe offers the best source for undertaking empirical analyses of income shifting.

BEA data

Figures 1 and 2 are from the 1999 and 2004 BEA surveys of US Direct Investment Abroad (the two most recent years available).[2] Figure 1 shows that pre-tax profitability is significantly higher for foreign affiliates in low tax jurisdictions than for affiliates in high tax jurisdiction, for both 1999 and 2004. These results provide evidence of income shifting. Figure 2 shows that the growth in profitability between 1999 and 2004 for these affiliates is significantly higher than the growth in sales in low tax jurisdictions, again indicative of income shifting. These data indicate that foreign affiliates of U.S. multinationals tend to have higher profitability in low tax jurisdictions, and that the

[1] The following discussion draws from a 2007 Treasury Report that examined the effectiveness of transfer pricing rules and compliance efforts in ensuring that cross-border transfers and other related party transactions could not be used to shift income improperly out of the United States. Department of the Treasury (2007), *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, Washington, DC: Department of the Treasury (November 2007). (the "2007 Treasury Report").

[2] Figures derived from: U.S. Bureau of Economic Analysis (2008),"U.S. Direct Investment Abroad: 2004 Final Benchmark Data," Washington, DC: U.S. Bureau of Economic Analysis (November), Tables Group III A1, B1, and E1; and, U.S. Bureau of Economic Analysis (2004), "U.S. Direct Investment Abroad: Final Results from the 1999 Benchmark Survey," Washington, DC: U.S. Bureau of Economic Analysis (April), Tables Group III A1, B1, and E1 and calculations by U.S. Treasury Department Office of Tax Analysis. Profits are defined as net income minus income from equity investments in foreign affiliates minus income from other equity investments plus foreign -income taxes.

growth of profitability tends to exceed the growth in sales, for example, in lower tax jurisdictions.

Figure 1: Foreign Affiliate Profitability by Local Tax Rate
Source: Bureau of Economic Analysis

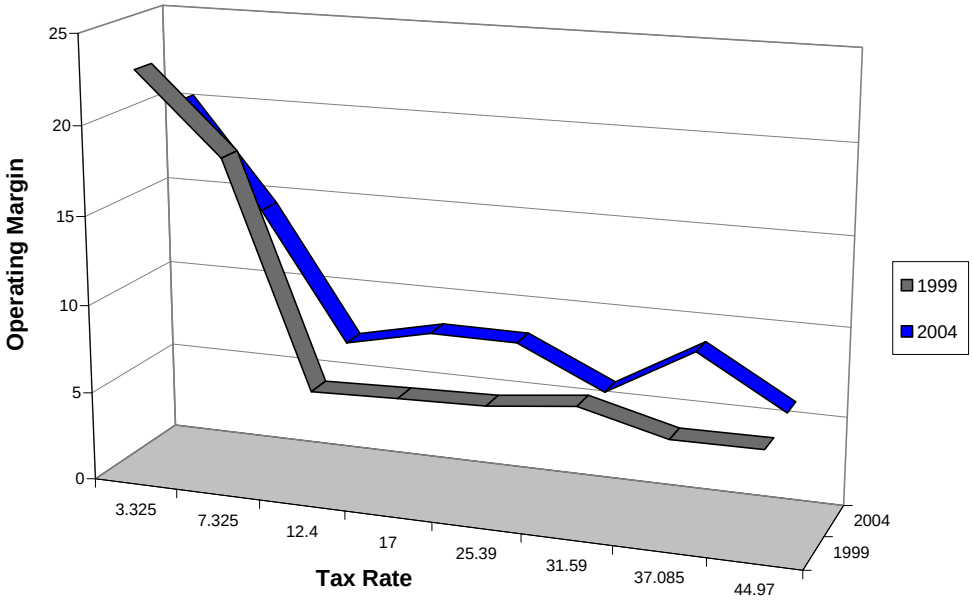
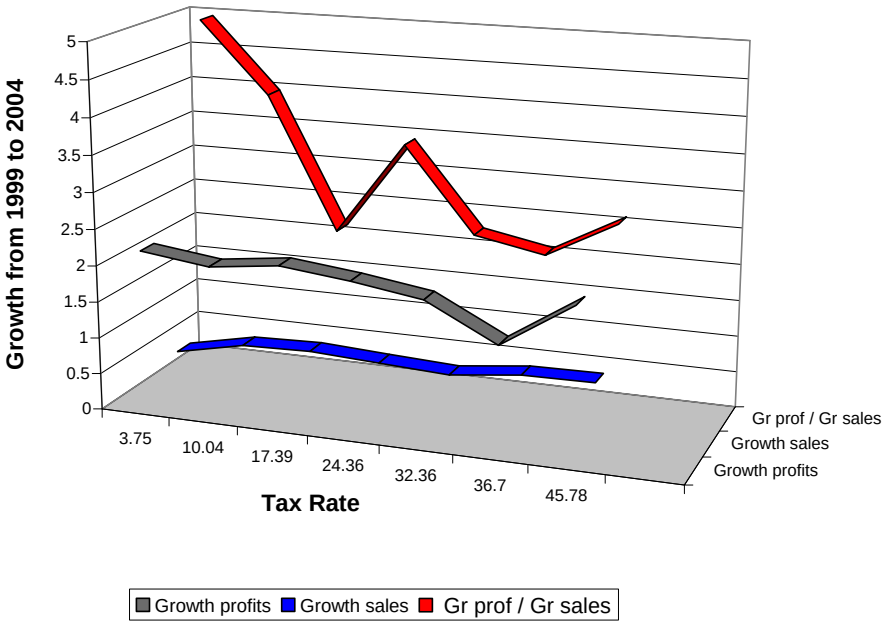


Figure 2: 1999-2004 Foreign Affiliate Growth in Profits and Sales by tax rate
Source: Bureau of Economic Analysis



I have two comments based on this data.[3] First, the data clearly raise questions as to the cause of this disparity in financial results. Second, the aggregated data do not allow for much insight into the extent to which these results are purely tax-driven, and in particular what aspects of the U.S. international tax system might contribute to the results.[4] A number of studies have attempted to partially address such questions statistically using this category of data.[5] These studies generally found that the pattern of profitability in high and low tax jurisdictions is consistent with income shifting behavior. The 2007 Treasury Report provides a more detailed summary of these studies.

Non tax-based company data

Company-level data based on non-tax public filings is often used to analyze profitability trends between domestic and foreign operations of particular U.S.-based

[3] Others have written and commented on these and similar data at some length See, for example, a number of analyses by Martin A. Sullivan: "U.S. Multinationals Paying Less Foreign Tax," 118 Tax Notes 1177-83 (March 17, 2008); "Extraordinary Profitability in Low-Tax Countries," 120 Tax Notes 724-727 (August 25, 2008); "U.S. Multinationals Moving Jobs to Low-Tax, Low-Wage Countries," 119 Tax Notes 119-123 (April 14, 2008); "U.S. Multinationals Shifting Profits Out of the United States," 118 Tax Notes 1078 - 1082 (March10, 2008); "Economic Analysis: The IRS Multibillion-Dollar Subsidy for Ireland," 108 Tax Notes 287 – 290 (July 19, 2005); "A New Era in Corporate Taxation," 110 Tax Notes 440 - 442 (January 31, 2006); "A Challenge to Conventional International Tax Wisdom," 113 Tax Notes 951 -961 (December 11, 2006); "Economic Analysis: Profit Shift out of U.S. Grows, Costing Treasury $10 Billion or More," 104 Tax Notes 1190 - 1193 (September 28, 2004); "U.S. Multinationals Move More Profits to Tax Havens," 102 Tax Notes 690 - 693 (February 9, 2004); "The Truth About Offshore Outsourcing and Profit Shifting," 102 Tax Notes 1187 - 1193 (March 8, 2004); "Economic Analysis: Data Show Dramatic Shift of Profits to Tax Havens," 104 Tax Notes 1109 - 1113 (September 13, 2004).

[4] BEA data are aggregated at the country level. Thus, for example, a single observation for a particular country in a particular year aggregates financial information for *every* majority owned foreign affiliate in that country for *every* U.S. multinational; the data do not allow, for example, discrimination between loss making companies and profitable companies, which is critically relevant in evaluating income shifting. Company-level data do allow for such discrimination. However, BEA data are not inferior to company-level data in all aspects. For example, BEA data treat disregarded hybrid entities as separate affiliates. CFC-level data, on the other hand, aggregates the results for all disregarded entities associated with the CFC that files Form 5471. In our view, the relative strengths of firm-level data compared to BEA data outweigh the relative weaknesses. We note, however, that the results of Figure 1, using BEA data, are generally consistent with the results of Figure 3, using CFC-level data – both data sources are indicative of income shifting. For a further discussion of source data, see GAO (2008), "U.S. Multinational Corporations Effective Tax Rates Are Correlated with Where Income is Reported," GAO-08-950, August 12, 2008.

[5] See, e.g., Grubert, Harry and John Mutti (1991), "Taxes, Tariffs and Transfer pricing in Multinational Corporation Decision Making," *Review of Economics and Statistics* 73(2) (May), pp. 285-293; Hines, James R., Jr., and Eric Rice (1994), "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics* 109(1) (February), pp. 149-182; Clausing, Kimberly A. (2006), "International Tax Avoidance and U.S. International Trade," *National Tax Journal* 59(2) (June), pp. 269-287; Clausing, Kimberly A. (2009), "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal* 62(4) (December), pp. 703-725. In addition, for a useful summary of the literature from all types of data sources, see Gravelle, Jane (2009), "Tax Havens: International Tax Avoidance and Evasion," *National Tax Journal* 62(4) (December), pp. 727-753.

multinationals. In terms of statistical analyses, this category of data tends to be superior to the first category for company-level statistical and econometric analysis. The literature has generally found that that the pattern of profitability in high and low tax jurisdictions is consistent with income shifting behavior. [6] The 2007 Treasury Report provides a more detailed summary of these studies.

Tax-based company data

Tax-based company data are the richest source of information available to analyze the extent of income shifting from transfer pricing, for two reasons. First, they derive directly from the corporate tax returns filed by U.S. multinationals, including tax forms associated with each controlled foreign corporation ("CFC") for which a multinational is a 10 percent shareholder. These data can be linked to relevant non-tax sources such as public financial filings. Second, tax-based company data allows for statistical analysis at the *individual CFC* level, which is even more detailed than the company level data described above.

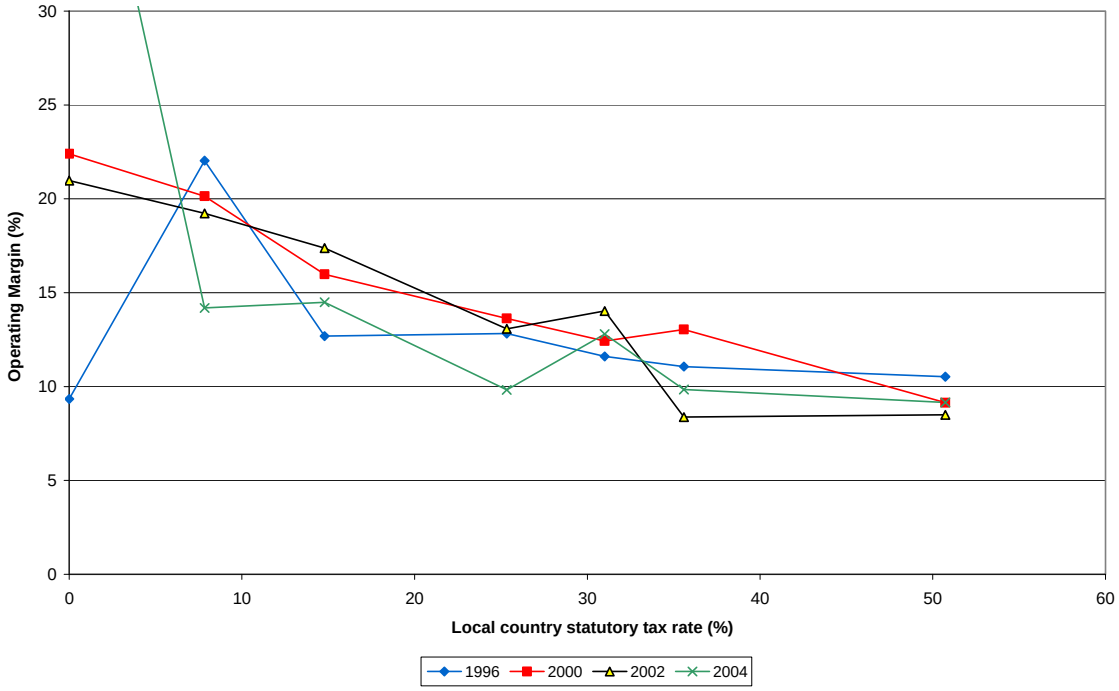
Figure 3 depicts the relationship between CFC profitability, measured by the ratio of operating profits to sales (or operating margin), and the statutory tax rate of the CFC's jurisdiction.[7] In general, the data show an inverse relationship between pre-tax

[6] See, e.g., Harris, David, Randall Morck, Joel Slemrod, and Bernard Yeung (1993), "Income Shifting in U.S. Multinational Corporations," in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, Chicago: University of Chicago Press; Harris, David G. (1993), "The Impact of U.S. Tax Law Revision on Multinational Corporations' Capital Location and Income-Shifting Decisions," *Journal of Accounting Research* 31 (Supplement), pp.111-140; Kemsley, Deen (2001), "Comment on 'The impact of Transfer Pricing on Intrafirm Trade'," in James R. Hines (ed.), *International Taxation and Multinational Activity*, Chicago: University of Chicago Press, pp. 194-199. For one study that suggests that transfer pricing may explain the income shifting see: Jacob, John (2003), "Taxes and Transfer Pricing: Income Shifting and the Volume of Intrafirm Transfers," *Journal of Accounting Research* 34 (2) (January), pp.301-312.

[7] The data used are derived from the corporate tax return (Form 1120) file for each of the years 1996, 2000, 2002, and 2004, merged with information from Form 5471 (an information return filed for each of the U.S. parent's CFCs), and Form 1118 (by which a U.S. parent calculates its foreign tax credit for foreign taxes paid by its CFCs and branches). These tax return data were further matched, where possible, to financial data reported in public filings (i.e., SEC filings) of the U.S. parent. The sample is derived from the data for the 7,500 largest CFCs, because detailed information is only available for them. The sample is further restricted by excluding financial CFCs and loss-making CFCs. Pre-tax profitability is defined as pre-tax earnings excluding interest income and interest expense, but including royalty income and royalty expense. The measure is based on "earnings and profits" (E&P), and is intended to approximate "book" operating profits for tax purposes. This measure of pre-tax operating profits has the advantage of being defined consistently across the taxing jurisdictions in which the CFCs operate. By excluding interest flows, the measure captures real ("above the line") activity related to, for example, the flows of tangible, intangible, and services transactions between related and unrelated parties. This operating margin measure has the further advantage of being a common "profit level indicator" when applying the comparable profits method under §1.482-5. Statutory tax rates are used rather than other measures (for example effective tax rates) because the shift of an additional dollar of income from one taxing jurisdiction to another would result in a change in tax equal to the difference in the marginal tax rates of the jurisdictions. The marginal tax rate is best measured by the jurisdiction's statutory tax rate.

profitability and tax rates, i.e., pre-tax profit margins are high in low tax jurisdictions and low in high tax jurisdictions. For example, in 2002 the weighted average pre-tax operating margins were over 20 percent for CFCs operating in tax jurisdictions with a zero percent statutory tax rate, while the pre-tax operating margins were under 8 percent for CFCs operating in tax jurisdictions with statutory tax rates over 35 percent.

Figure 3: CFC Profitability by Tax Rates: Non-financial CFCs



In order to examine more carefully the relationship between CFC profitability and local country tax rates, a number of studies have undertaken a more refined statistical approach using the tax-based company data that attempt to capture as many of the non-transfer pricing factors as possible.[8] I would like to focus on three of these studies. The first study evaluates the correlation between pre-tax profitability and local country statutory tax rates, controlling for non tax-related parent and CFC characteristics (for example, CFC asset intensity, parent size, years of operation for the CFC, and the

[8] See, e.g., Grubert, Harry and Joel Slemrod (1998), "The Effect of Taxes on Investment and Income Shifting to Puerto Rico," *Review of Economics and Statistics* 80 (3) (August) pp. 365-373; Altshuler, Rosanne, and Harry Grubert (2006), "The Three Parties in the Race to the Bottom: Host Countries, Home Countries, and Multinational Companies," 110 Tax Notes 979 - 992 (February 27, 2006); Grubert, Harry and John Mutti (2006), "New Developments in the Effect of Taxes on Royalties and the Migration of Intangible Assets Abroad," *NBER Working Paper* 13248 (July).

presence of intangible assets), and finds evidence of tax-induced income shifting, particularly associated with technology-based (rather than marketing) intangibles.[9]

A second study updates and expands upon the first study by excluding effects from intercompany debt, by extending the analysis through 2002, and by incorporating information more directly associated with transfer pricing – the use of cost sharing arrangements ("CSAs").[10]

The analyses provide two notable results. First, CFCs that engage in CSAs with their U.S. affiliates tend to be more profitable overall than other CFCs. Second, CFCs that engage in CSAs tend to have higher profitability in low tax jurisdictions and lower profitability in high tax jurisdictions than other CFCs, generally at statistically significant levels, when controlling for the other non-transfer pricing factors and the age of the CSA. These results suggest that CFCs that engage in CSAs with U.S. affiliates tend to show more evidence of income shifting.

The two studies I have discussed examine the relationship between CFC profitability and CFC taxes. These studies provide some insight into the tax-related incentives to shift income, but they do not directly address income shifting from the U.S. parent to its CFCs. The third study I would like to discuss uses tax-based company data to undertake such an analysis.[11] The study confirms that, in 1996 (the starting point of the analysis), not only did companies shift income from high tax foreign countries to low tax foreign countries, but also from the United States to abroad: the differential between U.S. and foreign tax rates resulted in a four percentage point increase in the foreign share of income. In addition, *since* 1996 there has been a notable increase in the share of the worldwide income of U.S. multinational companies that is declared abroad, from 37 percent in 1996 to 51 percent in 2004. The study finds that, out of this 14 percentage point increase in the foreign share of income, 4 percentage points (29 percent) are attributable to increased differentials between U.S. and foreign tax rates. The study also discusses U.S. international tax rules that have contributed to the decrease in foreign taxes, such as the so-called check-the-box provisions and the active finance exception, and how those rules interact with transfer pricing to contribute to income shifting.

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[9] Grubert, Harry. "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location." National Tax Journal, 56(1) Part 2 (March) pp. 221-242.

[10] McDonald, Michael (2008), "Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data," OTA Technical Working Paper 2 (July). A CSA is an arrangement by which controlled participants share the costs and risks of developing intangibles in proportion to their expected benefits from exploiting these intangibles. Typically, one of the parties has existing intangibles or other platform contributions that are relevant to the development of the cost-shared intangible, for which the other participants must compensate them through a "buy-in" payment. Through its detailed audits of cost sharing arrangements, the IRS believes that a significant number of taxpayers are systematically undervaluing buy-in payments, resulting in a non arm's-length shifting of income from the United States to low tax jurisdictions. This is an example of the "direct evidence" to which I referred earlier.

[11] Grubert, Harry (2009). "Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren't Being Globalized, Only Profits," Oxford University Centre for Business Taxation Working Paper WP09/26 (September).

This is not an exhaustive summary of the empirical evidence on income shifting, but highlights the evidence that we found most relevant in assessing our transfer pricing rules. We conclude based on our review of the available data and studies that there is evidence of substantial income shifting through transfer pricing.

We continue to believe that the arm's-length standard provides the appropriate basis for clearly reflecting income among affiliates. We also believe that the standard provides the most effective way to avoid double taxation, because, in general, it provides a principled basis for mutual agreement between taxing jurisdictions. However, we have been, and we continue to be, very concerned about income shifting from non-arm's length transfer pricing. The Administration has proposed addressing this issue through specific remedies that will reduce the effects of and the incentives to engage in income shifting. Towards that end, I would like to briefly touch upon this Administration's legislative proposals affecting transfer pricing, the Treasury's ongoing program to update regulations and achieve agreement on transfer pricing standards with other countries, and initiatives by the Internal Revenue Service to improve administration and enforcement of transfer pricing rules.

Administration Actions

The Administration has made important legislative proposals to address inappropriate reduction of U.S. tax through shifting profits offshore. In its FY2011 Budget, the Administration proposes to reduce inappropriate shifting of income outside the United States by clarifying the definition of intangible property, the valuation of multiple properties on an aggregate basis where that achieves a more reliable result, and the valuation of intangible property taking into account the prices or profits that a controlled taxpayer could have realized through realistically available alternative transactions.

The Administration would further attack income shifting with a new proposal on intangibles, providing that where a U.S. person transfers an intangible from the United States to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return will be treated as subpart F income in a separate foreign tax credit limitation basket.

In addition, since the 2007 Treasury Report was released, the Treasury Department has significantly revised the transfer pricing regulations. In January 2009 comprehensive temporary cost sharing regulations were published that included new methods for valuing the assets each party contributes to the arrangement. Additional guidance was also included which more clearly identified the scope and nature of the cost sharing activity and prescribed how the IRS could make adjustments to ensure that the income with respect to the transfer of intangible assets is commensurate with the income attributable to the intangible.

In August 2009 final regulations regarding the compensation for services between affiliates were published. These regulations significantly revised the treatment of controlled services transactions and the allocation of income from intangible property, in particular with respect to contributions by a controlled party to the value of intangible property owned by another controlled party. These revised rules were a necessary update, reflecting the importance and rapid innovation of cross-border services in an increasingly globalized economy.

The Treasury Department continues its work on revision of the global dealing rules and has incorporated updated guidance on attribution of profits to permanent establishments in treaties with several important trading partners.

Treasury has also participated in the OECD's projects on transfer pricing. In the absence of a common understanding among our trading partners on how transfer pricing issues should be addressed, they may lead to significant uncertainty for business and governments as well as possible double taxation or double non-taxation.

One such OECD project is the revision of the Transfer Pricing Guidelines. The most important aspects of that revision are the elimination of the hierarchy of transfer pricing methods and more detailed guidance on performing a comparability analysis and on the application of the transactional profit methods. The revision brings the Guidelines closer to the U.S. transfer pricing rules and will result in less double taxation of cross border transactions because of increasing global conformity of domestic transfer pricing rules.

Internal Revenue Service Transfer Pricing Initiatives

The IRS devotes substantial resources to addressing transfer pricing. For example, from 2007 through 2009, the IRS had an average of 1900 open examinations on transfer pricing issues. Since 2007, the IRS has strategically managed cases involving the migration of intangibles through three separate Issue Management Teams.[12]

The IRS has also successfully utilized alternative dispute resolution mechanisms in the area. Since 1991, it has conducted an Advance Pricing Agreement program through which taxpayers have reached agreement with the IRS on the proper treatment of transfer pricing issues for multiple taxable years, prior to filing tax returns for those years. Since the program's inception, the IRS has concluded approximately 950 APAs for an estimated 500 taxpayers, the majority of which cover large transactions in excess of $250 million.

More recently, the IRS initiated the development of a new Transfer Pricing Practice in its Large and Mid-Sized Business division. The initiative is currently in a pilot phase and

[12] These issue management teams are devoted to (1) the use of Cost Sharing Arrangements, (2) the treatment of stock based compensation in connection with Cost Sharing Arrangements, and (3) the migration of intangibles in connection with "Section 936 Exit Strategies."

will harness and leverage IRS knowledge and experience to bring additional resources and focus to the most significant transfer pricing issues.

Conclusion

Mr. Chairman and Ranking Member Camp, thank you for the opportunity to appear before the Committee to discuss the important topic of transfer pricing. As I mentioned at the beginning of my testimony, our analysis has found evidence of substantial income shifting from transfer pricing. The Administration has been and will continue to be focused on reducing the incentives that exist to engage in income shifting through inappropriate transfer pricing. We appreciate the Committee's continuing interest in this area and we look forward to working with the Committee to develop appropriate responses. I would be happy to respond to any questions you may have.