Report to The Congress on

Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties

Department of the Treasury
November 2007

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

NOV 28 2007

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Sections 424 and 806 of P.L. 108-357, the American Jobs Creation Act of 2004 (AJCA), directed the Secretary of the Treasury to conduct studies of certain issues regarding earnings stripping, transfer pricing, and U.S. income tax treaties and to provide specific recommendations in those areas. AJCA directed the Secretary to submit a report of such studies to the Congress. Pursuant to that directive, we hereby submit the "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties."

Section 806 of AJCA also directed the Secretary of the Treasury to conduct a study of the effectiveness of the provisions in AJCA on corporate expatriation. Because the provisions on corporate expatriation are relatively new and there is a need for further published guidance on them, more time is needed to assess their impact. Consequently, the study relating to the impact of AJCA's corporate expatriation provisions will be presented in a separate report at a later date.

I am sending a similar letter to Representative Charles Rangel, Chairman of the Committee on Ways and Means, Senator Charles Grassley, and Representative Jim McCrery.

Sincerely,

Eric Solomon

Eric Solomon
Assistant Secretary
Tax Policy

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

NOV 28 2007

The Honorable Charles B. Rangel
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Sections 424 and 806 of P.L. 108-357, the American Jobs Creation Act of 2004 (AJCA), directed the Secretary of the Treasury to conduct studies of certain issues regarding earnings stripping, transfer pricing, and U.S. income tax treaties and to provide specific recommendations in those areas. AJCA directed the Secretary to submit a report of such studies to the Congress. Pursuant to that directive, we hereby submit the "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties."

Section 806 of AJCA also directed the Secretary of the Treasury to conduct a study of the effectiveness of the provisions in AJCA on corporate expatriation. Because the provisions on corporate expatriation are relatively new and there is a need for further published guidance on them, more time is needed to assess their impact. Consequently, the study relating to the impact of AJCA's corporate expatriation provisions will be presented in a separate report at a later date.

I am sending a similar letter to Senator Max Baucus, Chairman of the Committee on Finance, Senator Charles Grassley, and Representative Jim McCrery.

Sincerely,

Eric Solomon

Eric Solomon
Assistant Secretary
Tax Policy

Enclosure

This is a linked table of contents. Click on entry to access page.

TABLE OF CONTENTS

This table of tables and this table of figures are linked to content. Click on entry to access page.

LIST OF TABLES AND FIGURES

Tables Page

Figures

I. INTRODUCTION AND SUMMARY

A. Introduction

This report was prepared in response to sections 424 and 806 of the American Jobs Creation Act of 2004 ("AJCA"). In AJCA, Congress directed the Secretary of the Treasury to conduct studies regarding (1) the earnings stripping rules, including a study of the effectiveness of these rules in preventing the shifting of income outside the United States; (2) the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property; (3) income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist; and (4) the impact of AJCA's corporate expatriation provisions on inversion transactions (i.e., where a U.S. parent corporation of a U.S. multinational group is replaced with a new foreign parent corporation).

This integrated report provides the results of the Treasury Department's analysis of the first three studies. Chapter II of this report is the study on earnings stripping. Chapter III of this report is the study on transfer pricing. Finally, chapter IV of this report is the study on U.S. income tax treaties. The first three studies are presented together in this integrated report, rather than issued separately, because of the common thread, which links them together – the potential for exploitation of inappropriate income-shifting opportunities to erode the U.S. corporate tax base. Since that theme underlies all three study areas, it seemed most appropriate to present results as part of a unified overall report.

This Treasury Department report does not address at this time the fourth study area – the impact of the expatriation provisions on inversion transactions. Section 7874, enacted as part of AJCA, is a relatively new provision and more time is needed to assess the impact of the provision in this area. Since its enactment, the Treasury Department has issued two sets of temporary and proposed regulations interpreting section 7874 and is in the process of revising and finalizing the regulations. In addition, there is an ongoing need for further published guidance under section 7874. These steps must be taken before a thorough study of the effectiveness of this section can be completed. Consequently, the results of the fourth study relating to the impact of AJCA's expatriation provisions on inversion transactions will be presented in a separate report at a later date.

B. Background

On May 17, 2002, the Treasury Department issued a preliminary report on corporate inversions (Treasury Department inversion report). An inversion is a transaction through which the corporate structure of a U.S.-based multinational corporation is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group. These transactions involve little or no immediate operational change in the corporate group. However, the transactions produce at least two major areas of tax benefit. First, they facilitate "stripping" of the U.S. tax base attributable to the foreign operations of the corporate group. Second, the transactions facilitate the stripping of the

U.S. tax base attributable to the U.S. operations of the corporate group. The first major tax benefit is achieved by migrating ownership of the former U.S. parent corporation's existing foreign subsidiaries outside the United States. This migration is coupled with having the group's new foreign operations held outside the United States upon their formation or acquisition. Consequently, when all the transaction steps are completed, the foreign operations of the corporation are generally outside U.S. taxing jurisdiction, reducing or even eliminating the U.S. tax on foreign operations. The second major tax benefit is achieved by leveraging the U.S. parent corporation and the U.S. group as part of the inversion transaction. The leveraging of the U.S. operations of the group is accomplished through intercompany loans from related foreign entities. The result is a major reduction in the level of U.S. tax on domestic operations of the group through deductible interest payments to foreign members of the overall group that are subject to little or no U.S. tax. In the SEC filings seeking shareholder approval of these transactions, significant reductions in U.S. corporate taxes are listed as a key reason that the former U.S. parent corporations undertook these transactions.

In its study of inversion transactions, the Treasury Department pinpointed the tax benefits critical to the operation of these transactions, namely shifting earnings out of U.S. taxing jurisdiction through a variety of techniques. These techniques included the migration of foreign subsidiaries and the introduction of leverage in the U.S. group as described above, as well as transfer pricing and U.S. income tax treaty-based techniques. The Treasury Department concluded, however, that the manner that the provisions of the Internal Revenue Code (the "Code") and our income tax treaties are exploited in these transactions is not necessarily unique to corporations that had undergone an inversion transaction. For example, these techniques are available to any foreign-controlled corporate group, regardless of whether the corporation undergoes an inversion transaction to become such a group. Consequently, the conclusion of the Treasury Department inversion report was that inversion transactions simply exposed areas of weakness in the Code and U.S. income tax treaties. Accordingly, the Treasury Department inversion report concluded that further study of the rules that facilitate earnings stripping through the payment of interest on intercompany loans (i.e., section 163(j) and reductions of withholding taxes through income tax treaties) and the rules related to stripping the U.S. corporate tax base through transfer pricing (i.e., section 482) are necessary.

While the Treasury Department studied inversion transactions and issued its report, members of Congress introduced a variety of legislative proposals to deal with corporate inversion transactions. Some of these legislative proposals related to the tax treatment of the inversion transaction itself. Others proposals related to what some perceived as the root causes of the transactions, such as weakness in the earnings stripping and transfer pricing rules. Other proposals combined these approaches. At the same time, a variety of proposals were being considered to update and reform the U.S. international tax rules more generally in order to make U.S.-based multinationals more competitive with foreign-based multinationals in the global marketplace.

AJCA, enacted on October 22, 2004, made significant changes to tax rules that apply to cross-border investment and transactions. The provisions in AJCA included repeal of the Extraterritorial Income Exclusion and tax changes for U.S. business operating abroad, particularly regarding the foreign tax credit. AJCA also included a

one-time incentive to reinvest foreign earnings in the United States. In addition, AJCA contained provisions to reduce tax avoidance through individual and corporate expatriation. In particular, AJCA enacted section 7874, which directly addresses the structural results and certain tax consequences of a wide range of inversion transactions. AJCA did not, however, specifically alter other provisions relevant to the dynamics of inversion transactions, namely the earnings stripping provisions, the transfer pricing provisions of section 482, or provisions relating to treaty abuse (e.g., section 894). However, Congress did request in sections 424 and 806 of AJCA that the Treasury Department conduct studies of these three inversion-related provisions, as well as the effectiveness of section 7874 of the Code.

Section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations. Temporary and proposed regulations were issued under that section in December 2005 and May 2006. The Treasury Department believes these regulations are an effective implementation of Congressional intent. Nonetheless, there is currently a need for further published guidance under section 7874, and the existing temporary and proposed regulations must be finalized. These efforts are in process. Because the guidance process and our study of the effectiveness of this provision are ongoing, the fourth report requested by AJCA will be issued separately.

C. Summary

As indicated above, this report addresses three areas of study requested by AJCA. The studies in this report are with respect to earnings stripping, transfer pricing, and tax treaties. Brief summaries of these studies follow.

1. Earnings-Stripping Study

The focus of the earnings-stripping study is on earnings stripping by foreign-controlled domestic corporations. As discussed below, it is not possible to quantify with precision the extent of earnings stripping by foreign-controlled domestic corporations generally. However, there is strong evidence of earnings stripping by the subset of foreign-controlled domestic corporations consisting of inverted corporations (i.e., former U.S.-based multinationals that have undergone inversion transactions).

The overall effect of income stripping on U.S. employment is unclear. The theoretical effect of income shifting on cross-border investment in the United States is ambiguous, because income shifting may either increase or decrease investment in a high-tax country. Empirical studies show that foreign direct investment depends negatively on a country's corporate tax rate. Relatively high U.S. corporate tax rates, thus, likely decrease foreign investment in the United States. However, existing studies do not address the question of how income shifting affects cross-border investment. The level of investment by multinationals is unlikely to affect total employment in the United States significantly unless there is unemployment in the markets for labor whose skills foreign investors demand.

The study on earnings stripping concludes by analyzing a number of proposals aimed at restricting the ability of foreign-controlled domestic corporations to strip income out of the United States -- some of which have been suggested by others and some of which have been developed within the Treasury Department. The earnings stripping

study did not find conclusive evidence of earnings stripping from foreign-controlled domestic corporations that had not inverted. However, there is strong evidence that inverted corporations have engaged in earnings stripping. The corporate-inversion provisions in AJCA do not affect taxpayers who inverted before March 5, 2003, but recent Administration Budget proposals would. These Administration Budget proposals would also affect taxpayers other than inverted corporations.

The earnings-stripping study in this report concludes that additional information is needed to determine how the Administration's Budget proposal would affect foreign-controlled domestic corporations that have not inverted and whether modifications to the proposal would be appropriate. In order to obtain this additional information and further the administration of section 163(j), a new tax form has been created, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*.

2. Transfer Pricing Study

The transfer pricing study focuses on issues in the transfer pricing area relating to shifting income from the United States (both in the context of inversion transactions and more generally). Specifically, the study reviews Treasury regulatory guidance under section 482 and the effectiveness of current transfer pricing rules and compliance efforts to ensure that related-party transactions cannot be used to shift income out of the United States improperly. In addition, the study reviews the administration of the section 482 rules. In that regard, the study indicates that the transfer pricing rules must be continually monitored to ensure their relevance to changing business conditions and to prevent income shifting from non-arm's length transfer pricing. The empirical evidence available from tax return data is consistent with (although not proof of) ongoing non-arm's length pricing or income shifting among related parties. As discussed below, a key outcome of this conclusion is the need for the Treasury Department to complete the process of finalizing and modernizing its transfer pricing guidance.

In this regard, three areas of particular concern stand out among related-party transactions generally. First, proposed revisions to the existing cost sharing rules must be completed regarding the type and valuation of external contributions (i.e., "buy-in" payments) for which arm's length consideration must be provided as a condition to entering into a cost sharing arrangement. The cost sharing area is a crucial one regarding the shifting of income out of the United States. An important first step in this regard was proposed regulations issued in 2005. The Treasury Department is currently working to finalize the proposed regulations.

Second, proposed revisions to the related-party services regulations must be completed to reflect legal, business, and economic developments since the regulations were issued in 1968. Updated guidance on the transfer pricing methods to be used to determine the arm's length price in a services transaction needs to be completed, and it should be consistent with current regulations applicable to transfers of tangible and intangible property. Changes to the existing cost safe harbor for low-margin, back-office services must be completed, and guidance is needed to coordinate and harmonize the rules applicable to services related to intangibles with the transfer pricing rules applicable

to transfers of intangible property generally. Temporary and proposed regulations have been issued addressing these issues and are undergoing revision before they are finalized.

Third, new rules are needed to allow taxpayers to determine the amount of income from a global dealing operation that is subject to tax in the United States, as well as the source of such income and the circumstances under which such income is effectively connected with a U.S. trade or business. Proposed regulations in this regard are being drafted and will be issued soon. After comments are received and analyzed, the Treasury Department will finalize these regulations.

The transfer pricing study of this integrated report concludes that high priority should be given to prompt finalization and implementation of the three transfer pricing regulatory projects described above. These regulations will address known gaps in transfer pricing administration, and will alleviate common avenues for income shifting from non-arm's length transfer pricing available to multinational corporations. Once these regulations are issued in final form, further study and consideration may be appropriate. However, given the current disclosure requirements already in place (as well as the additional disclosure requirements that are part of the proposed regulations), the generally high audit rates of affected taxpayers, and the enhanced ability of the competent authority to exchange information with other tax jurisdictions, the Treasury Department does not recommend additional disclosure requirements at this time.

3. U.S. Income Tax Treaties Study

The study on U.S. income tax treaties in this integrated report focuses on combating abuses of treaty-based withholding rate reductions, particularly with respect to payments of dividends, interest, and insurance premiums. In addition, the tax-treaty study focuses on the need to prevent third-country residents from inappropriately obtaining the benefits of U.S. income tax treaties, in particular by achieving inappropriate reductions in U.S. withholding taxes. Especially important in this regard are limitation on benefits ("LOB") provisions that deny treaty benefits to corporations with insufficient business and economic connection to their claimed country of residence.

The LOB provisions are the critical area of consideration for purposes of this study. Empirical evidence from U.S. corporate tax returns reveals that in recent years the total interest payments from foreign-controlled U.S. corporations to related parties in countries that are a party to a U.S. tax treaty with no LOB provisions and significant reductions in withholding rates (Iceland and Hungary) have surged. Many of the Icelandic and Hungarian corporations claiming treaty benefits are ultimately owned by persons from third countries (i.e., they would not be entitled to treaty benefits generally under most LOB provisions). The data are consistent with ongoing abuse of these treaties. A similar concern exists with respect to the U.S.-Poland tax treaty, which also lacks an LOB provision and provides significant reductions in withholding rates, although the data do not indicate that third-country investors are exploiting the U.S.-Poland treaty as heavily as the U.S.-Iceland and U.S.-Hungary treaties.

Evidence of such exploitation of treaties without anti-treaty shopping protections leads to two conclusions. First, the LOB provisions in other U.S. agreements appear to provide significant deterrence against this sort of abuse. Second, the evidence underscores the importance of the Treasury Department's ongoing efforts to revise the

treaties with no or inadequate LOB provisions. These efforts are consistent with the emerging international consensus regarding the need to prevent third-country residents from inappropriately obtaining the benefits of bilateral income tax treaties, and serve to safeguard the U.S. tax-treaty network against possible abuse in the future. The Treasury Department has made significant progress in this regard. The most noteworthy development to date is the signing of a new income tax treaty with Iceland in October 2007. The new treaty conforms closely to the current tax treaty policies of both the United States and Iceland and contains a comprehensive LOB provision which will ensure that only residents of the United States and Iceland will enjoy the benefits of the agreement.

II. STUDY OF EARNINGS STRIPPING

A. Introduction

Section 424(a) of AJCA included the following mandate for a study of earnings stripping provisions:

> (a) IN GENERAL- The Secretary of the Treasury or the Secretary's delegate shall conduct a study of the effectiveness of the provisions of the Internal Revenue Code of 1986 applicable to earnings stripping, including a study of—
>
> (1) the effectiveness of section 163(j) of such Code in preventing the shifting of income outside the United States,
>
> (2) whether any deficiencies of such provisions place United States-based businesses at a competitive disadvantage relative to foreign-based businesses,
>
> (3) the impact of earnings stripping activities on the United States tax base,
>
> (4) whether laws of foreign countries facilitate stripping of earnings out of the United States, and
>
> (5) whether changes to the earning stripping rules would affect jobs in the United States.

The report should also include specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.

Earnings stripping usually refers to the payment of excessive deductible interest by a U.S. corporation to a related person when such interest is tax exempt (or partially tax exempt) in the hands of the related person. Consequently, the Treasury Department has interpreted section 424 of AJCA to be a mandate primarily to study the shifting of income of domestic corporations offshore through related-party debt and associated interest payments. Although payments of other deductible amounts by a U.S. corporation to tax-exempt or partially exempt related parties also provide an opportunity to shift income out of a U.S. corporation, the use of related-party debt arguably is the most readily available method of shifting income out of U.S. corporations.[1] Income shifting through interest payments is certainly the most recognizable manner of shifting income in this context. It should be noted that chapter III of this integrated report discusses the shifting of income out of the United States through transfer pricing.

Due to the focus on the use of earnings stripping to shift income outside the United States, this study in chapter II concentrates on earnings stripping by foreign-

[1]The U.S. tax on U.S. operations is easily reduced through deductions for interest payments on intercompany debt. A U.S. subsidiary can be loaded up with a disproportionate amount of debt for earnings-stripping purposes through the issuance of an intercompany note. This does not require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may result in a change in tax position but also may require a real change in business operations.

controlled domestic corporations ("FCDCs").[2] In this context, a foreign-controlled domestic corporation is a U.S. corporation in which one foreign person owns, directly or indirectly, more than 50 percent of (a) the total voting power of all classes of stock of the corporation entitled to vote, or (b) the total value of all classes of stock of the corporation.[3] U.S. corporations that are not foreign-controlled domestic corporations are referred to as "domestically controlled corporations" ("DCCs"). In part, the focus on FCDCs is due to concerns about the possibility of shifting income and jobs outside the United States. In addition, earnings stripping may be more difficult in the case of DCCs. For example, the subpart F provisions of the Code limit the ability of DCCs to shift income offshore by means of interest payments to foreign subsidiaries.[4]

B. Executive Summary

FCDCs have opportunities to reduce their U.S. taxable income by leveraging their U.S. operations with debt, the interest on which is not subject to U.S. tax in whole or in part.

Historically, FCDCs have been relatively less profitable compared to DCCs, which, at first blush, might suggest the possibility that FCDCs may be improperly reducing their U.S. taxable income. However, analysis of tax return data for 2004 did not find conclusive evidence of a higher ratio of interest expense to cash flow for FCDCs compared with DCCs in the nonfinancial sector and in the manufacturing industry (which is part of the nonfinancial sector), although the ratio appears to be higher for FCDCs in securities dealing and investment banking. The data are not conclusive that the reason for this low profitability of FCDCs relative to DCCs is a result of earnings stripping.

The data gathered with respect to inverted corporations ("ICs"), however, strongly suggest that these corporations are stripping substantially all of their income out of the United States, primarily through interest payments. Consequently, these corporations' U.S. operations are very unprofitable. Evidence of earnings stripping by ICs suggests that in this context the current rules of section 163(j) are not effective at preventing the shifting of income inappropriately outside the United States.

The overall effect of income stripping on U.S. employment is unclear. The theoretical effect of income shifting on cross-border investment in the U.S. is ambiguous, because income shifting may either increase or decrease investment in a high-tax country. Empirical studies show that foreign direct investment depends negatively on a country's corporate tax rate. Relatively high U.S. corporate tax rates, thus, likely decrease foreign investment in the United States. However, existing studies do not address the question of how income shifting affects cross-border investment. The level of investment by multinationals is unlikely to affect total employment significantly in the United States,

---

[2] Although partnerships, limited liability companies (LLCs), and other non-corporate entities may be involved in earnings stripping as well, corporations are frequently the most important parties either directly or indirectly using such entities.

[3] This information is reported on the Corporate Income Tax Return, Form 1120, Schedule K.

[4] Multinational DCCs can and typically do allocate a disproportionate share of the debt from their global operations to the United States, however. Data in the Bureau of Economic Analysis Benchmark Surveys of Direct Investment Abroad have indicated that U.S. parents have more debt in relation to assets than their foreign affiliates. There is also evidence in Grubert and Altshuler (2003) that U.S. companies allocate much more of their debt abroad to high-tax countries compared to low-tax countries.

unless there is unemployment in the markets for labor whose skills foreign investors demand.

The earnings-stripping study did not find conclusive evidence of earnings stripping from FCDCs that had not inverted. However, there is strong evidence that ICs have engaged in earnings stripping. The study concludes that additional information is needed to determine how the Administration's Budget proposal would affect FCDCs that have not inverted and whether modifications to the proposal would be appropriate. In order to obtain this additional information and further the administration of section 163(j), a new tax form has been created, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*.

C. Background

Section 163(j) was added to the Code by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) to prevent erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to a tax-exempt (or partially tax-exempt) related person.[5] Section 163(j) applies where a corporation's debt-to-equity ratio exceeds 1.5 to 1 and its net interest expense exceeds 50 percent of its adjusted taxable income (generally computed by adding back net interest expense, depreciation, amortization, depletion, and the net operating loss deduction). If the corporation exceeds the thresholds, no deduction is allowed for interest in excess of the 50-percent limit that is paid to a related party and that is not subject to U.S. income tax. Interest is treated as not subject to U.S. income tax to the extent an applicable income tax treaty reduces the U.S. income tax on such interest. Disallowed interest amounts may be carried forward indefinitely. In addition, the excess of the 50-percent limit over a corporation's net interest expense for the year (if any) may be carried forward three years. Special rules also apply in the case of interest paid or accrued to a partnership. For purposes of these rules, all members of the same affiliated group of corporations are treated as one taxpayer.

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) broadened the scope of section 163(j) to apply to interest paid with respect to certain loans between unrelated parties. Section 163(j) applies where a corporate borrower pays or accrues interest to an unrelated party if the interest is not subject to a gross basis income tax and the guarantor is a foreign person or a tax-exempt entity.

In 1991, the Treasury Department and the Internal Revenue Service (IRS) issued proposed regulations implementing section 163(j) of the Code. These regulations have not been finalized.

The efficacy of the current rules of section 163(j) has been questioned in the course of public discussion and legislative activity regarding corporate-inversion transactions. A feature common to many inversions is the presence of substantial indebtedness of the U.S. group to the new foreign parent or one of its foreign subsidiaries. The indebtedness can arise through the former U.S. parent's issuance of a note to the foreign corporation prior to the consummation of the inversion transaction.

---

[5] For purposes of section 163(j), a related person is any person who is related as defined in section 267(b) or section 707(b)(1).

Alternatively, it can arise after the inversion transaction through a distribution of a note to the new foreign parent. While the steps through which the debt is put in place vary, the result can be interest payments that effectively shift income out of the U.S. taxing jurisdiction. Where the foreign parent is not taxed by its country of residence and a comprehensive income tax treaty with the United States is applicable that provides for little or no withholding tax on interest, the tax-reduction benefit of this technique is maximized, as there is no offsetting increase in foreign taxes. However, even where the foreign parent is located in a country that generally imposes tax on it, the interest income earned may be subject to little foreign tax if, for example, the country specifically reduces taxation on financing structures. In any case, there is a net tax benefit whenever the foreign tax imposed on the interest income is less than the value of the U.S. tax deduction for the interest expense.

Inversion transactions provide evidence that the earnings stripping rules are not fully achieving their intended purposes and have led some to conclude that these rules need to be strengthened. The Treasury Department inversion report proposed that the rules regarding earnings stripping through related-party debt (i.e., section 163(j)), and reduced withholding rates in U.S. income tax treaties, be examined.[6] Moreover, the Treasury Department articulated in that report that because the opportunities for earnings stripping are not limited to inversion transactions but are present in cases where a U.S. business is structured from the outset with a foreign parent and in cases where a foreign corporation acquires a U.S. operating group, reconsideration of these rules should not be limited in application to inverted corporations. In addition, the President's Budget has included a proposal to amend section 163(j) in this regard since the FY 2004 Budget.

A number of congressional proposals have been introduced since 2002 to amend section 163(j) in response to an increase in the number of inversions. However, it should be noted that while amendments to section 163(j) were considered in the context of AJCA, AJCA as enacted did not contain an earnings stripping provision. Instead, AJCA required a study of the area. AJCA addressed key aspects of the inversion problem by adding section 7874 to the Code.

Section 7874 generally provides for certain tax consequences for inversion transactions where there has been significant continuity of ownership before and after the transaction. If there is at least 60 percent continuity of ownership between the old U.S. parent corporation and the new foreign parent corporation, section 7874 limits the ability to use tax attributes to offset any benefits resulting from the transaction. If there is at least 80 percent continuity of ownership between the old U.S. parent corporation and the new foreign parent corporation, section 7874 treats the new foreign parent corporation as a domestic corporation for income tax purposes. Section 7874 only applies to transactions after March 4, 2003, and so corporations that inverted before that time are unaffected.

The United States' major trading partners have thin capitalization rules similar to section 163(j), but the details of those rules differ among countries. A debt-to-equity ratio is often used, but sometimes it is a strict limit (e.g., interest on any debt that exceeds

[6]The study in chapter IV of this report examines any inappropriate reductions in U.S. withholding tax that provide opportunities for shifting income out of the United States.

the ratio is disallowed) rather than only a safe harbor as it is in the United States. Safe harbors employed by other countries include the worldwide group average debt-to-equity ratio, or a level that taxpayers can show would be acceptable to a third-party lender. Interest-coverage-ratio limits are also commonly employed.[7]

D. Evidence for the Existence and Extent of Earnings Stripping

1. Foreign-Controlled Domestic Corporations

FCDCs have the opportunity to reduce their U.S. taxable income by leveraging their U.S. operations. As noted above, section 163(j) may limit the deductibility of "excess interest expense" on loans from related parties in certain circumstances. However, there may be continuing opportunities to strip earnings notwithstanding section 163(j).

This section examines the evidence for the existence of earnings stripping by FCDCs by comparing their profitability and their use of debt to that of DCCs.

Profitability of FCDCs

Given that FCDCs have historically been relatively less profitable when compared to DCCs, some have suggested the possibility that FCDCs might be improperly reducing their U.S. taxable income. The persistence of this lower relative profitability of FCDCs is shown on Figure 2.1, which is derived from data from corporate income tax returns for large corporations for 1995 through 2003 and that are published in annual articles in the *Statistics of Income Bulletin.*[8] The profitability measure used in the comparison is the ratio of net income to total receipts.[9] These data show that, over this period, large FCDCs in the nonfinancial sector generally (which includes the manufacturing industry), and in the manufacturing industry specifically, were consistently less profitable than large DCCs. For most of these years, FCDCs in the financial sector were also less profitable than their domestic counterparts.

---

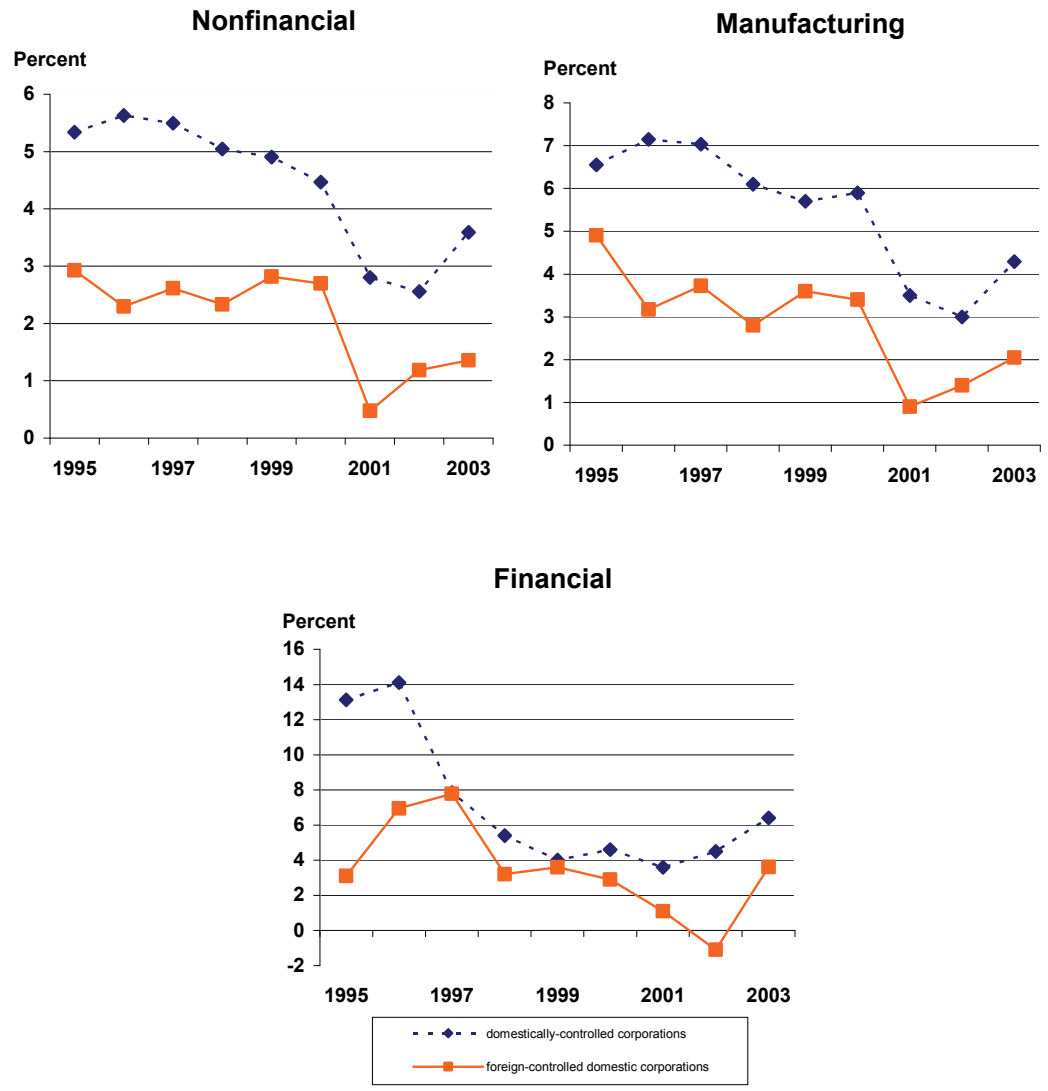
[7] For more details, see, e.g., IBFD (2006) and Morris (2006).

[8] http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96311,00.html#2

[9] Profitability is expressed relative to total receipts rather than total assets or equity because of the problems associated with assets reported on corporate tax returns. For example, assets are valued at historical book value (i.e., the value at the time of acquisition). Newly acquired assets generally have a higher book value than the assets they replaced. Comparisons using book-value measures may be misleading if either FCDCs or DCCs contain a larger share of corporations with newly acquired assets, such as new corporations. In addition, the balance sheet also includes foreign assets and liabilities, and corporations apparently vary on how these are stated (e.g., sometimes the foreign assets are on a gross basis and sometimes on a net equity basis). Also, corporations that file consolidated tax returns frequently do not net out intercompany assets and liabilities.

Net income is taxable income (total income less total deductions) before special deductions and the net operating loss deduction as reported on the corporate tax return (Form 1120, line 28). Total receipts include all of the income received by a corporation and reported on its tax return, including gross receipts before the deduction for cost of goods sold and business expenses, and interest on tax-exempt obligations. Large corporations are those with assets of $250 million or more and/or business receipts of $50 million or more. In Figure 2.1, FCDCs are those with 50 percent or more foreign ownership. The data exclude real estate investment trusts (REITs), regulated investment companies (RICs), S corporations, and corporations with foreign ownership between 25 percent and 50 percent.

Figure 2.1
Ratio of Net Income to Total Receipts for Large Domestic Corporations by Control Status and Industry: 1995-2003



Source: SOI Bulletin Articles (http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96311,00.html#2)

A more detailed examination of the profitability difference in 2004 (the most recent year for which tax return information is available) is presented in Table 2.1. It compares the ratio of net income to total receipts in all industries, the nonfinancial sector, manufacturing, and the financial sector by ownership category.[10] The three categories of U.S. corporations displayed are those that are more than 50 percent owned by foreigners,

[10] Table 2.1 is based on tabulations of data from Form 1120, the corporate income tax return. They differ somewhat from the tabulations published by the Statistics of Income Division, which were used to construct Figure 2.1. Unlike Figure 2.1, Table 2.1 is not restricted to large corporations. Also, Table 2.1 defines FCDCs as corporations with greater than 50 percent foreign ownership, whereas Figure 2.1 uses 50 percent or more foreign ownership.

those with 25 percent to 50 percent foreign ownership, and all other corporations (referred to here as domestically controlled). The estimated lower profitability of FCDCs compared with DCCs is evident in all groupings. For example, in manufacturing the ratio of net income to total receipts is about one-third lower for FCDCs (3.3 percent) than for DCCs (4.9 percent). The ratio of net income to total receipts is also substantially lower for FCDCs than for DCCs in the nonfinancial and financial sectors.

Table 2.1
The Ratio of Net Income to Total Receipts and Number of Corporate Tax Returns by Ownership Category and Sector: 2004

	All Industries	Nonfinancial	Manufacturing	Financial
Ownership Category	**Ratio of Net Income to Total Receipts (%)**			
Foreign Ownership > 50%	2.9	2.8	3.3	3.9
Foreign Ownership 25 - 50%	3.0	2.9	4.9	6.1
Domestically Controlled	4.3	3.8	4.9	6.6
	Number of Corporate Returns in Sample			
Foreign Ownership > 50%	10,202	8,243	2,671	1,959
Foreign Ownership 25 - 50%	832	724	238	108
Domestically Controlled	65,550	52,638	10,197	12,912

Notes: These estimates are based on data from corporate income tax returns for 2004. They exclude REITs, RICs, S corporations, and branches of foreign corporations filing on Form 1120F. Number of returns is unweighted.

The analysis in this section of the study explores the sources of this profitability differential. Several explanations for the difference in profitability are possible, such as a different structure of assets and income, a greater reliance on debt, and the manipulation of prices in intercompany transactions. It is also possible that foreign investors systematically tend to acquire less promising corporations.[11] The low profitability of FCDCs in the United States has been studied by Grubert, Goodspeed and Swensen (1993) and Grubert (1997).[12] This section updates the results in some of these earlier studies and extends the analysis to the financial sector.

A basic question in studying the profitability of FCDCs is which corporations should be used as a basis of comparison. Figure 2.1 compares FCDCs to domestic corporations that are not foreign controlled, implicitly using the latter as the "control" group. A similar approach is adopted in this chapter, which uses DCCs as the focus of the comparisons with FCDCs. It is possible that multinational corporations ("MNCs") based in the United States (i.e., DCCs with foreign subsidiaries) shift income out of the United States. However, excluding U.S. MNCs from the comparison group would leave purely domestic corporations that may have special characteristics, such as lower profitability and fewer intangible assets, which may limit their opportunities for investing abroad. Corporations in the 25 percent to 50 percent foreign ownership category might

[11]Most foreign-controlled corporations in the United States were the product of acquisitions and were not start-ups.
[12]See also Blouin, Collins, and Shackelford (2001).

be a potentially suitable control group because minority ownership probably offers fewer opportunities for income shifting. However, the small size of the 25 percent to 50 percent foreign ownership category is problematic especially at the level of specific industries and makes it difficult to use in drawing reliable conclusions.

Grubert (1997) indicated that one of the asymmetries between FCDCs and DCCs is that DCCs receive a substantial amount of income in the form of dividends and royalties, mainly from subsidiaries abroad. Therefore, net income does not accurately reflect the profitability of DCC domestic operations alone. In order to isolate domestic operations and some of the more relevant factors that may explain the differences in profitability of DCCs and FCDCs, "operating income" is calculated from amounts reported on corporate tax returns. Operating income is defined as net income (taxable income before special deductions and the net operating loss deduction) plus interest expense, depreciation, amortization, and depletion and minus interest, dividends, and royalties received. Thus, operating income is total income with all purely financial receipts and deductions eliminated.[13] It is a better measure than net income, because it focuses on corporations' U.S. domestic operations (i.e., it adjusts for the relatively large amount of foreign investment income received by DCCs that is largely unrelated to their domestic operations).

Table 2.2 starts with the ratio of *net* income to total receipts shown in Table 2.1 and displays the components of the adjustment from net income to operating income. The last row in each section of Table 2.2 shows the ratio of *operating* income to total receipts for FCDCs and DCCs in the nonfinancial sector and in manufacturing, respectively.[14] Whereas FCDCs are less profitable than DCCs in the nonfinancial sector and in manufacturing when the ratio of net income to total receipts is used as the measure of profitability, that profitability difference disappears when profitability is measured on the basis of operating income. In the nonfinancial sector, FCDCs are slightly more profitable than DCCs in terms of operating income (6.3 percent for FCDCs compared with 5.5 percent for DCCs). In manufacturing, FCDCs are significantly more profitable than DCCs in terms of operating income (7.9 percent for FCDCs compared with 5.9 percent for DCCs). An important reason for these differences is that DCCs receive a greater amount of dividends and royalties relative to total receipts (which are subtracted from net income in computing operating income), particularly in manufacturing where corporations have significant foreign operations.

Table 2.2 also shows that depreciation and amortization deductions as a share of total receipts are roughly the same for DCCs and FCDCs. Both interest paid and received are higher for DCCs than for FCDCs in the nonfinancial sector as well as manufacturing. This difference may reflect greater financial activities of DCCs compared with FCDCs, and perhaps the difficulties and arbitrariness of classifying corporations that have both significant financial and manufacturing aspects of their business.

[13]Interest expense, the main subject of this section, is explored separately below.
[14]Table 2.2 excludes financial corporations because interest income and expense are an intrinsic part of their business operations.

Table 2.2
Net Income Adjusted to Operating Income
in the Nonfinancial Sector and Manufacturing
by Ownership Category: 2004

	Nonfinancial		
	Foreign Control	**Foreign Ownership 25 - 50%**	**Domestic Control**
Net Income / Total Receipts	2.8	2.9	3.8
Plus:			
Interest Paid / Total Receipts	3.1	1.8	3.8
Depreciation & Amortization / Total Receipts	4.2	3.9	4.4
Depletion / Total Receipts	0.1	0.1	0.1
Minus:			
Dividends Received / Total Receipts	0.5	0.5	1.2
Interest Received / Total Receipts	2.9	0.7	4.4
Royalties Received / Total Receipts	0.5	1.2	1.0
Operating Income / Total Receipts	6.3	6.3	5.5
	Manufacturing		
	Foreign Control	**Foreign Ownership 25 - 50%**	**Domestic Control**
Net Income / Total Receipts	3.3	4.9	4.9
Plus:			
Interest Paid / Total Receipts	2.4	2.3	3.2
Depreciation & Amortization / Total Receipts	4.3	5.0	4.0
Depletion / Total Receipts	0.1	0.0	0.1
Minus:			
Dividends Received / Total Receipts	0.4	0.7	2.1
Interest Received / Total Receipts	1.3	0.8	2.4
Royalties Received / Total Receipts	0.5	1.4	1.8
Operating Income / Total Receipts	7.9	9.3	5.9

Notes: Shares reported as percentages. Operating Income = Net Income + Interest Paid + Depreciation + Depletion - Dividends - Royalties - Interest Received. The estimates are based on data from corporate income tax returns for 2004. They exclude RICs, REITs, and S corporations.

As noted earlier, the higher profitability of FCDCs compared to DCCs when operating income is used as the profitability measure does not mean that FCDCs are not shifting income out of the United States. The comparison is at an aggregate level and may not account for systematic differences between FCDCs and DCCs at the level of the firm that may affect profitability.[15] Further, the domestic-corporation control group also may be shifting income out of the United States. For example, Figure 2.1 shows that the ratio of net income to receipts of U.S. corporations in manufacturing declined

[15]The statistical analysis summarized below attempts to control for other factors that may affect profitability.

substantially from 1995 to 2003, based on the net income (including repatriated foreign income) that is reported on corporate tax returns.[16,17]

The relationship between net income and operating income is also examined using statistical regression methods that can control for other factors that contribute to profitability, such as the age of the corporation (based on its date of incorporation) and its reliance on outside purchases.[18] The age of the corporation is used to test the possibility that some of the net income difference between FCDCs and DCCs is attributable to start-up costs by relatively immature FCDCs.[19] A greater reliance on outside suppliers would be associated with a lower ratio of net income to receipts because the corporation would require less of its own capital per unit of receipts. For example, wholesalers tend to have lower margins on profits on sales than manufacturers because they contribute a smaller share of the total value added in the final product. The results based on firm-level data from the 2004 corporate tax returns were consistent with the aggregate tabulations in Tables 2.1 and 2.2, which were also based on 2004 data. Before the addition of the other explanatory variables, the difference in the ratio of net income to total receipts in the firm-level analysis was large and about the same magnitude as in Table 2.1. The addition of the additional age and purchases explanatory variables to the firm-level analysis reduced the initial estimated difference by more than half. The addition of the reliance on purchases was particularly significant. When using operating income as the profitability measure in the regressions, FCDCs had a substantially higher ratio of operating income to receipts than DCCs in both the nonfinancial sector and in manufacturing (consistent with Table 2.2). Thus, based on operating income, FCDCs were found to be at least as profitable as DCCs.

Debt and Earnings Stripping

Section 163(j) is directed at taxpayers that have very high interest expense relative to cash flow. Whereas Table 2.2 provided information on average interest expense relative to total receipts, this subsection analyzes the distribution of interest paid relative to cash flow by FCDCs and DCCs. The distributions are presented for all industries and separately for the nonfinancial sector, manufacturing, and the financial sector (excluding

---

[16]Grubert (1997) found that the profitability of FCDCs was more clustered near zero than DCCs and were more likely to revert to that pattern than DCCs. That result was sensitive to whether profitability was expressed relative to sales or assets; the difference was much smaller with sales. The analysis in this section does not use assets, because of the measurement problems noted above, such as the problems associated with historical book values.

[17]Some have also suggested that data showing that the rate of earnings on foreign-owned U.S. assets is less than the rate of earnings on U.S-owned foreign assets provide evidence of earnings stripping by foreign entities out of the United States. (See, e.g., *The Economist* (2006) for a general discussion.) However, there are other possible explanations. A much greater share of U.S. foreign direct investment abroad is start-up rather than acquisitions, whereas most foreign direct investment in the United States is through acquisitions. Further, U.S. companies have relatively more intangible assets. In addition, U.S. companies may shift income out of the United States, which would raise the measured rate of return on U.S.-owned foreign assets above the true rate of return.

[18]These results are described in detail in Grubert (2007). In the regression analyses, DCCs include corporations in the 25 percent to 50 percent foreign ownership category.

[19]The age of a corporation is determined based upon the date of incorporation reported on its tax return. A recent incorporation date may indicate a new start-up corporation, but it may also reflect a new incorporation as a result of a recent acquisition or merger of previously existing corporations.

insurance and real estate). The extent to which FCDCs and DCCs rely on debt also was examined using regression and other statistical methods that attempt to control for firm-specific factors that may affect a firm's ability to borrow and thus its interest expense.

The Nonfinancial Sector

Table 2.3 presents the percentage of FCDC and DCC total receipts and total cash flow accounted for by corporations in selected intervals of the ratio of interest paid to cash flow.[20] Cash flow is defined as net income (before net operating loss deductions) plus interest paid, depreciation, depletion, and amortization. Therefore, cash flow is total receipts less current direct expenses, such as wages and the cost of materials. The ratio of interest paid to cash flow is similar to the ratio of net interest expense to adjusted taxable income used to calculate disallowed interest in section 163(j). The difference in the two ratios is that for purposes of section 163(j) net interest expense is calculated by subtracting interest income from gross interest paid to determine net interest expense and adjusted taxable income. The ratio of interest paid to cash flow used in this analysis does not deduct interest income from gross interest expense in determining interest paid or cash flow.

The ratio of interest paid to cash flow is computed for each corporation. Based on the result of that calculation, each corporation is assigned to the appropriate interval of the ratio of interest paid to cash flow. The frequency distribution is determined using two sets of weights — receipts and cash flow.[21]

Table 2.3 indicates that, in the nonfinancial sector and in the manufacturing industry, it is very difficult to identify major differences in the frequency of high interest expense (i.e., a ratio of interest expense to cash flow of 50 percent or more). In the nonfinancial sector, the comparison of FCDCs and DCCs with interest expense equal to 50 percent or more of cash flow provides mixed results, depending on whether receipts or cash flow are used as weights. The share of total receipts is 16.2 percent for FCDCs (12.6 percent plus 3.6 percent) and 13.4 percent for DCCs (8.4 percent plus 5.0 percent). However, the share of total cash flow is approximately the same for both FCDCs and DCCs: 20.4 percent for FCDCs (18.0 plus 2.4 percent) compared to 20.3 percent for DCCs (17.5 percent plus 2.8 percent). On the other hand, DCCs with interest expense of 75 percent or more of cash flow are more likely to have high interest expense than FCDCs using either receipts or cash flow as weights.

In the manufacturing industry, DCCs are somewhat more likely than FCDCs to have high interest expense in relation to cash flow. FCDCs with interest expense equal to 50 percent or more of cash flow accounted for 10.4 percent of FCDC total receipts (6.6 percent plus 3.8 percent) and 10.6 percent of FCDC total cash flow (7.9 percent plus 2.7 percent). In contrast, DCCs with interest expense equal to 50 percent or more of cash flow accounted for 13.7 percent of DCC total receipts (8.8 percent plus 4.9 percent) and 16.2 percent of DCC total cash flow (14.0 percent plus 2.2 percent).

---

[20]Corporations with 25 percent to 50 percent foreign ownership are not included in Table 2.3.

[21]These measures were used as weights in the frequency distribution because they take into account corporations' varying size. A frequency distribution based on the number of corporations would be misleading because it would assign the same weight to small corporations as to large corporations.

Table 2.3
Distribution of the Ratio of Interest Paid to Cash Flow: 2004

All Industries				
Interest Paid/Cash Flow	Percentage of Total Receipts		Percentage of Total Cash Flow	
	Foreign Control	Domestic Control	Foreign Control	Domestic Control
.00 ≤ ratio < .25	62.7	61.9	50.1	49.0
.25 ≤ ratio < .50	19.1	22.4	21.5	21.1
.50 ≤ ratio < .75	12.4	8.7	16.1	17.0
.75 or more	5.9	7.0	12.3	13.0
Total	100.0	100.0	100.0	100.0

Nonfinancial				
Interest Paid/Cash Flow	Percentage of Total Receipts		Percentage of Total Cash Flow	
	Foreign Control	Domestic Control	Foreign Control	Domestic Control
.00 ≤ ratio < .25	64.4	63.8	55.6	56.5
.25 ≤ ratio < .50	19.4	22.7	24.1	23.1
.50 ≤ ratio < .75	12.6	8.4	18.0	17.5
.75 or more	3.6	5.0	2.4	2.8
Total	100.0	100.0	100.0	100.0

Manufacturing				
Interest Paid/Cash Flow	Percentage of Total Receipts		Percentage of Total Cash Flow	
	Foreign Control	Domestic Control	Foreign Control	Domestic Control
.00 ≤ ratio < .25	69.3	61.1	62.7	62.4
.25 ≤ ratio < .50	20.3	25.2	26.6	21.5
.50 ≤ ratio < .75	6.6	8.8	7.9	14.0
.75 or more	3.8	4.9	2.7	2.2
Total	100.0	100.0	100.0	100.0

Financial				
Interest Paid/Cash Flow	Percentage of Total Receipts		Percentage of Total Cash Flow	
	Foreign Control	Domestic Control	Foreign Control	Domestic Control
.00 ≤ ratio < .25	16.7	18.5	16.7	9.5
.25 ≤ ratio < .50	9.1	16.4	6.5	10.8
.50 ≤ ratio < .75	5.0	15.2	5.2	14.5
.75 or more	69.1	49.9	71.6	65.3
i. .75 ≤ ratio < .90	18.8	25.6	17.9	27.9
ii. .90 ≤ ratio < .95	37.9	4.8	39.1	6.1
iii. .95 ≤ ratio < 1.0	1.4	18.0	2.5	29.7
iv. ratio ≥ 1	11.0	1.5	12.1	1.6
Total	100.0	100.0	100.0	100.0

Note: These estimates are based on data from corporate income tax returns for 2004. They exclude REITs, RICs, S corporations, and branches of foreign corporations filing on Form 1120F and corporations in the 25 percent to 50 percent ownership category. The financial sector excludes insurance and real estate.

The comparison of FCDCs and DCCs in manufacturing with interest expense equal to 75 or more of cash flow yields a somewhat more mixed picture, with the result depending on whether receipts or cash flow are used as weights. Corporations with interest expense equal to 75 percent or more of cash flow account for 3.8 percent of FCDC total receipts compared to 4.9 percent of DCC total receipts. However, corporations with interest expense equal to 75 percent or more of cash flow accounted for 2.7 percent of FCDC total cash flow compared to 2.2 percent of DCC total cash flow.

The extent to which FCDCs and DCCs rely on debt, including the frequency with which corporations have high interest expense, was also examined with regressions and other statistical methods using firm-level tax return data. These statistical analyses supplement the analysis in Table 2.3 by controlling for a number of factors that may increase a corporation's ability to borrow, such as a liquid composition of assets and a large amount of interest income. Like Table 2.3, the indicator of interest expense used in the regression analysis is the ratio of interest expense to cash flow. In the numerator of that ratio, interest income is not deducted from interest expense. However, in the regression analysis, the ratio of interest income to total receipts (or alternatively cash flow) is included as an explanatory variable to reflect the possibility that corporations with greater interest income can be more highly leveraged.[22]

The statistical analysis indicated that on average FCDCs in the nonfinancial sector and in the manufacturing industry had interest expense relative to cash flow virtually the same as comparable DCCs.[23] In addition, the firm-level statistical analysis examined whether FCDCs were more likely to have high levels of interest expense in relation to cash flow, using the section 163(j) threshold of 50 percent (without the 163(j) netting of interest income from interest expense). The results show that in 2004 FCDCs were less likely to be above the threshold than were comparable DCCs. They were also less likely to have a ratio of interest paid to cash flow greater than 75 percent.

The Financial Sector

Corporations in the financial sector generally have much greater leverage than corporations in the nonfinancial sector. Because financial corporations are much more likely to be highly leveraged than nonfinancial corporations, a threshold ratio of interest expense to cash flow of 90 percent, rather than the 50 percent threshold discussed above, may be a more appropriate measure of high interest expense. Using the 90-percent threshold ratio of interest expense to cash flow, Table 2.3 shows that FCDCs in the financial sector[24] do seem to be more likely to have high levels of interest expense relative to cash flow compared to DCCs, but the comparison is not completely unambiguous. Corporations with interest expense of 90 percent or more of cash flow

[22]The regression analysis does not use debt measures based on the balance sheet that corporations submit as part of their corporate tax return. The balance sheet data are unreliable for this purpose for several reasons, including the historical book value and other measurement problems discussed above. Cash flow may be a better indicator of the true value of assets.

[23]Utilities are excluded from the nonfinancial sector in the regressions because of the special features of rate regulated industries, such as the ability to issue a large amount of debt.

[24]Insurance corporations and real estate corporations are excluded from the financial sector for this purpose because they are likely to have a much different relationship between interest expense and cash flow than other financial intermediaries.

account for 50.3 percent of FCDC total receipts[25] compared to 24.3 percent of DCC total receipts,[26] and 53.7 percent of FCDC total cash flow[27] compared to 37.4 percent of DCC total cash flow.[28] In the financial sector, FCDCs are also much more likely than DCCs to have interest expense greater than or equal to cash flow, measured either in terms of the share of total receipts or total cash flow. However, a greater share of total receipts and total cash flow are above the 95-percent threshold for DCCs than for FCDCs. A significant share of DCC total receipts and total cash flow (18.0 percent and 29.7 percent, respectively) fall in the 95 percent to 100 percent category.[29]

A more detailed examination of corporations in selected industries within the financial sector (commercial banks, securities dealers and investment banks, stock life and property and casualty insurance, and real estate) indicated that FCDCs in those industries exhibit a wide range of profitability. Commercial bank FCDCs had a slightly lower ratio of net income to receipts than domestically controlled banks, but any discrepancy seems largely attributable to the greater amount of dividends that domestic banks receive. Domestically controlled international banks receive dividends from their foreign affiliates, but in the case of banks that are FCDCs the comparable dividends go to the home country. However, the profitability differential between FCDCs and DCCs that are securities dealers and investment banks was substantial in 2004, with net income equal to 4.2 percent of receipts for FCDCs compared to 7.1 percent for DCCs, and a wide disparity was also notable in 2002 and 2003, the other years examined in detail. The ratio of net income to receipts was similar for stock life insurance FCDCs and their domestically controlled counterparts in 2004 (as well as in 2002 and 2003). However, stock property and casualty FCDCs were much less profitable than DCCs, net income being equal to 1.4 percent of receipts for the former versus 6.4 percent for the latter. The FCDCs in property and casualty insurance also had large losses in 2002 when DCCs were profitable and they had meager profits compared to DCCs in 2003. Finally, FCDCs in real estate had a higher ratio of net income to receipts than comparable DCCs in each of the three years and they also had much less debt.

As in the case of nonfinancial industries above, firm-level analysis of the debt and interest expense in commercial banking and in securities dealing and investment banking was undertaken. This makes it possible to control for the type of assets a corporation holds and whether it receives substantial financial income, such as interest. The issue is whether FCDCs in these sectors are much more likely to have high interest expense relative to cash flow.[30]

---

[25] 50.3 percent is the sum of 37.9 percent, 1.4 percent and 11.0 percent.
[26] 24.3 percent is the sum of 4.8 percent, 18.0 percent and 1.5 percent.
[27] 53.7 percent is the sum of 39.1 percent, 2.5 percent and 12.1 percent.
[28] 37.4 percent is the sum of 6.1 percent, 29.7 percent, and 1.6 percent.
[29] Corporations in the financial sector tend not to be constrained by 163(j) because they can net interest income from interest paid. Because financial intermediaries earn an interest spread, they can frequently have negative *net* interest expense.
[30] As above in the case of nonfinancial corporations, cash flow is defined as the sum of net income, interest paid, depreciation expense, depletion, and amortization. Unlike section 163(j), interest income is not netted from interest expense in the numerator of the interest expense-to-cash-flow ratio in calculating which corporations are above the threshold.

In the case of commercial banks, FCDCs were somewhat more likely to be above the 90-percent threshold than comparable DCCs. In securities dealing and investment banking FCDCs the difference was much larger. For example, the probability that a domestic corporation in securities dealing and investment banking paid more than 90 percent of cash flow in interest was very low, but greater than 40 percent in the case of FCDCs. FCDCs were also much more likely to pay more than 95 percent of their cash flow in interest.

Summary

The analyses of corporate tax return data for 2004 did not find conclusive evidence that FCDCs have very high interest expense relative to cash flow compared to DCCs in the nonfinancial sector and in the manufacturing industry.[31] In the financial sector, FCDCs in securities dealing and investment banking appear to have very high interest expense relative to cash flow. However, in general it is difficult to make precise estimates or to draw firm conclusions because of the possibility of alternative explanations and the problems with using DCCs as a comparison group.

2. Inverted Corporations

In contrast to the data on all FCDCs, data on ICs strongly suggest that these corporations are shifting substantially all of their income out of the United States, primarily through interest payments.

Seida and Wempe (2004) compare pre-inversion taxes and post-inversion taxes paid by ICs.[32] They find large reductions in effective tax rates and evidence of widespread income shifting out of the United States. (Because Seida and Wempe use accounting data from annual reports, "IC" in the context of their study refers to the consolidated worldwide group rather than simply the U.S. subsidiaries of the group.)

The authors examine the financial statements of 12 ICs and 24 similar control corporations (selected based in part on industry classification and level of sales) and find that ICs had a significantly larger increase in foreign income and profit margin and a significantly larger decrease in U.S. profit margin and effective tax rate than the control corporations. For the ICs, the foreign profit margin nearly doubles, the U.S. profit margin is driven negative, and the worldwide effective tax rate is reduced by one-third.

---

[31]It should be noted that the number of ICs are so small in number relative to all other FCDCs that any earnings stripping or lack of earnings stripping activity by ICs would have a very negligible effect on the data relating to FCDCs.

[32]Seida and Wempe select inverted corporations for their study by the following procedure. They searched SEC filings for corporations domiciled in one of the 41 countries identified as tax havens in the OECD 2000 Progress Report. They made sure that corporations had at least one year of Compustat data available, moved their domicile from the United States, were not private corporations immediately before and after inversion, did not have a contemporaneous event (such as a spin-off) at the time of their inversion, went through with their proposed inversion, and were not insurance corporations (which the authors assert do not consistently disclose the geographic sources of pre-tax income). Seida and Wempe's sample of 12 corporations, thus, appears to exclude a number of corporations they would consider to be inverted but for which insufficient data are available for their study purposes, for which the effects of an inversion cannot be isolated easily, or are corporations that inverted from a country other than the United States. Seida and Wempe study only corporations, not other types of businesses. They also do not study tax-haven corporations generally. When we discuss inverted corporations in the context of Seida and Wempe's study, the term "ICs" will have the meaning of an inverted corporation as they have selected.

The authors conclude that these data are consistent with the view that the primary motivation for U.S. inversions is to reduce U.S. taxation significantly.

The authors look more closely at four ICs that provide detailed information on the levels of intercompany debt and interest and fee expense. The authors show that the levels of these items increased significantly post-inversion. For three of the four corporations, the amounts of these items located in the U.S. operations of the corporation can be determined and, in each case, most of the long-term debt and interest and fee expense is attributable to the U.S. operations.[33] These data are consistent with the view that the primary means of income shifting by these corporations is through related-party debt and interest payments, in other words earnings stripping.

The Treasury Department extended the analysis of earnings stripping by all FCDCs, described in section 1 above, by creating an indicator for ICs. Of the 12 ICs studied by Seida and Wempe, two had been acquired by U.S. corporations by 2002 and, thus, were no longer inverted. All the necessary data for three other corporations could not be obtained, probably because they were not large enough to be in the top 7,500 corporations that comprise our sample of corporate tax returns.

For the remaining seven corporations, the primary U.S. taxpaying entity was determined by comparing subsidiaries listed in parent-corporation annual reports for 2002 with those listed on the 2002 IRS Form 851 (which lists subsidiaries included in a consolidated filing) of the U.S. filing entity. These primary U.S. taxpaying corporations were extremely unprofitable.

The Treasury Department also examined the payments declared on Form 5472 for these seven corporations.[34] These data suggest the majority of stripping is through interest, but some takes place through royalties. This is not surprising, because interest and royalties are the two major deductible income payments made between corporations, and treaty withholding-tax rates are often zero for interest and royalties.

This analysis differs somewhat from Seida and Wempe's work in that it compares ICs to a large number of other FCDCs and domestic corporations that did not invert for a single year, while Seida and Wempe compare differences in profitability pre-inversion and post-inversion between ICs and their close competitors who did not invert for the three years immediately prior to and immediately after inversion. The inversions they analyze occurred in the time period from 1994 to 2002. The differences in methodology help provide independent confirmation of the conclusions.

There do not appear to have been any high-profile inversions as defined by Seida and Wempe since 2002, which may be due to the enactment of section 7874. While section 7874 has likely prevented new inversions, those that occurred before the March 4, 2003 effective date are grandfathered. These existing, grandfathered ICs are the corporations that Seida and Wempe studied and that have been analyzed in this study.

---

[33]Disclosure of data on intercompany debt and interest and fee expense are required by SEC regulations when a subsidiary issues debt guaranteed by its parent.

[34]The Form 5472 is an information return of a 25 percent or more foreign-owned U.S. corporation or a foreign corporation engaged in a U.S. trade or business. It includes data on transactions between FCDCs and foreign related parties.

E. The Effectiveness of Section 163(j) in Preventing Income Shifting

Because we are unable to quantify accurately the extent of income shifting by FCDCs generally, it is not possible to determine with precision whether section 163(j) is effective in preventing it. Some have suggested that the absence of strong evidence of earnings stripping by FCDCs indicates that earnings-stripping rules of section 163(j) are serving their intended purpose. Others believe that the data are not certain enough to support this conclusion.

As discussed above, however, there is strong evidence that ICs are stripping. Seida and Wempe (2004) state that section 163(j) is ineffective in stopping the stripping of essentially 100 percent of their income out of the United States by the four ICs for which sufficiently detailed data are available. The authors state that all four corporations appear to be within the 1.5-to-1 debt-to-equity safe harbor of section 163(j). They do not discuss whether or not the 50 percent of adjusted taxable income limit is exceeded by the related-party interest payments of ICs. These data indicate that at the very least modifications to section 163(j) are needed to address the problems of earnings stripping by existing ICs.

F. The Effect of Deficiencies of Earnings Stripping Provisions on the Competitiveness of U.S.-Based Businesses

Any deficiencies of the U.S. earnings-stripping provisions that allow foreign-based corporations to strip earnings out of the United States without allowing U.S. corporations to do so provide a tax advantage to foreign corporations that do business in the United States and, therefore, provide them with a competitive advantage.

Among the FCDCs, the ICs provide the clearest evidence of earnings stripping out of their U.S. operations. Earnings stripping by ICs puts U.S.-based businesses at a competitive disadvantage.

G. The Impact of Earnings Stripping Activities on the U.S. Tax Base

As discussed above, the Treasury Department cannot accurately quantify earnings stripping by FCDCs. Thus, the effect on the U.S. tax base is unclear. However, Seida and Wempe (2004) calculate the reduction in tax revenue to the U.S. Treasury for the four ICs for which they have sufficient data to be in excess of $700 million for the two-year period from 2002 to 2003. As these four corporations are a subset of the total number of ICs, the revenue loss for all ICs would be considerably larger.

H. The Effect of Foreign Laws on Stripping of Earnings Out of the United States

Foreign country tax laws may facilitate the stripping of income out of the United States. For example, foreign corporations based in no-tax or low-tax countries gain from stripping income from the United States to those countries by the differential in tax rates multiplied by the amount of stripped income. Other corporations may be based in high-tax countries that exempt or allow deferral of tax on income earned offshore, so that corporations resident in those countries can strip income from the United States to a third, no-tax or low-tax country without incurring either U.S. tax or tax in their home countries.

There are many no-tax or low-tax countries, many high-tax countries with special low-rate offshore regimes, and many high-tax countries that allow exemption or deferral of foreign source active income. On the other hand, many high-tax countries have rules (known as controlled foreign corporation ("CFC") rules) designed to tax foreign earnings currently if earned in low-tax countries. These rules, thus, may discourage corporations resident in those countries from stripping earnings out of the United States.

I. The Effect of Changes to the Earning-Stripping Rules on Jobs in the United States

The effect of cross-border income stripping on employment has two components: (1) the effect of income stripping on cross-border investment, and (2) the effect of cross-border investment on employment. This section reviews the economics literature evaluating both of these effects.[35]

1. The Effect of Taxation and Income Stripping on Corporate Investment

Multinational corporations ("MNCs") can shift income out of high-tax countries and allocate it to low-tax countries by several means, including leverage, royalty payments, and transfer pricing. All of these techniques can be used to increase deductions on investment in high-tax countries, thereby lowering the effective tax rate and raising the after-tax return on that investment. The critical tax rate for income shifting is the differential between the nominal corporate tax rates in the home and host countries (or, where a MNC has multiple subsidiaries, the corporate tax rate differential between the high-tax and low-tax host countries). Because the United States has high statutory corporate tax rates relative to other member countries of the Organisation for Economic Cooperation and Development (OECD),[36] it is likely that income shifting would be used to strip taxable income out of the United States.

The effect on investment of international tax differentials and the income shifting opportunities to which they give rise is ambiguous. By lowering the effective tax rate in high-tax jurisdictions, income shifting may support investment in those jurisdictions. However, the capacity to shift income may lead corporations to invest in low-tax jurisdictions in order to allocate taxable income to those jurisdictions. In general, income shifting lowers a corporation's marginal cost of capital in both home and host countries.[37]

How international corporate tax differentials affect corporate investment is ultimately an empirical question. The literature on the effect of international tax differentials on foreign direct investment is reviewed in de Mooij and Ederveen (2003). Analyzing the results of 25 different studies of the effect of international tax differentials on foreign direct investment ("FDI"), the authors find a median elasticity of foreign investment to the host-country tax rate of -3.3, indicating that a 1-percent decrease in the corporate tax rate will lead to a 3.3-percent increase in foreign direct investment. Relatively high U.S. corporate tax rates, thus, likely decrease foreign investment in the United States. However, existing empirical work does not address the question of whether income shifting raises or lowers the level of investment in high-tax countries.

---

[35]The literature does not focus exclusively on earnings stripping through related party debt. Thus, the discussion in this section refers to income stripping.
[36]CBO (2005).
[37]Grubert (2003).

2. The Effect of Foreign Investment on Employment

As Baldwin (1995) points out, U.S. employment depends more on domestic factors such as labor and product-market flexibility and work-force composition than on the level of foreign investment or trade. In equilibrium, any increase (decrease) in foreign investment is likely to be at least partially offset by a decrease (increase) in domestic investment because the capital inflow (outflow) will alter domestic factor prices as well as the exchange rate, if it is flexible.

For example, an increase in inbound foreign investment creates higher demand for U.S. factors such as labor, thereby reducing unemployment and/or raising wages. To the extent that it increases wages, it will crowd out some domestic investment and labor demand, dampening the expansionary effects of the capital inflow. Higher real wages also result in increased import demand and reduced export demand. The initial capital inflow may appreciate the U.S. dollar, which will also tend to lower the trade balance.[38]

J. Conclusions

The focus of this chapter is on earnings stripping by FCDCs. FCDCs have opportunities to reduce their U.S. taxable income by leveraging their U.S. operations with debt, the interest on which is tax exempt or partially tax exempt for the recipient. The possibility that FCDCs may be reducing their taxable income is suggested by the fact that historically they have been relatively unprofitable compared to the DCCs. However, an analysis of corporate tax return data for 2004 did not find conclusive evidence that the reason for the low profitability of FCDCs compared to DCCs is a result of earnings stripping.

In 2004, FCDCs in the nonfinancial sector did not have higher average levels of interest expense relative to cash flow than DCCs. Further, an analysis of the ratio of interest expense relative to cash flow found that FCDCs also are not more likely to have high interest expense (e.g., interest expense equal to 50 percent or more of cash flow) than DCCs. Although FCDCs in the nonfinancial sector historically have earned lower net income as a percentage of receipts than DCCs, for 2004 the difference in relative net income was largely attributable to the larger amount of dividends and royalties relative to receipts for DCCs, particularly in the manufacturing industry where corporations have significant foreign operations. Nevertheless, the absence of conclusive evidence does not imply that FCDCs in the nonfinancial sector are not engaging in earnings stripping. The

[38]Although foreign investment may have little effect on long-run total employment, it may nonetheless alter the composition of employment, thereby affecting wages for different segments of the labor force. For example, an OECD (1994) employment study shows that foreign investment by industrialized countries in developing countries may erode employment in labor-intensive industries in industrialized countries. Riker and Brainard (1997) corroborate this finding, showing that MNCs tend to allocate jobs according to national skill levels, with skilled employment concentrated in industrialized countries and unskilled employment concentrated in developing countries. Thus, foreign investment both into and out of the United States may decrease demand for unskilled U.S. labor but increase demand for skilled U.S. labor.

comparison group includes DCCs with foreign subsidiaries that also may be earnings stripping by locating debt from their global operations in the United States.

In the financial sector, FCDCs in different industries exhibited widely different profitability. For example, FCDCs in real estate were more profitable than DCCs, FCDCs and DCCs in the stock life insurance industry were similarly profitable, but FCDCs in property and casualty insurance were much less profitable than DCCs. FCDCs in securities dealing and investment banking were much less profitable than DCCs in that industry and were much more likely to have very high interest expense relative to cash flow.

In view of those findings, it is difficult to make precise estimates or to draw firm conclusions. Because the Treasury Department is unable to quantify accurately the extent of earnings stripping by FCDCs generally, it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by FCDCs.

There is strong evidence that ICs are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping.

The relative lack of evidence of earnings stripping by FCDCs generally relative to ICs might be seen to suggest that earnings stripping is less attractive to FCDCs than to ICs. This may be due in part to the fact that foreign parents of ICs are based in no-tax or low-tax countries, while many foreign parents of FCDCs are based in high-tax countries whose laws may cause reductions in U.S. taxes from interest payments to be partly or fully offset by increased foreign taxes on the interest income. Another possible explanation may be that it is easier to quantify income stripping by ICs because ICs can be compared to the same corporations pre-inversion. In contrast, our comparison group for FCDCs is DCCs, which differ in many more ways besides country of incorporation.

The effect of earnings stripping on the U.S. tax base is unclear, because we cannot accurately quantify earnings stripping by FCDCs generally. However, Seida and Wempe (2004) calculate the reduction in tax revenue to the U.S. Treasury for the four ICs for which they have sufficient data to be in excess of $700 million for the two-year period from 2002 to 2003. As these four corporations are a subset of the total universe of ICs, the revenue loss for all ICs would be considerably larger.

Any deficiencies of the U.S. earnings-stripping provisions that allow foreign-based corporations to strip earnings out of the United States without allowing U.S. corporations to do so provide a U.S. tax advantage to foreign corporations that do business in the United States. Foreign taxes may partially or fully offset this tax advantage, however. The tax laws of foreign countries encourage earnings stripping out of the United States to the extent that the interest income is subject to little or no foreign tax.

The overall effect of income stripping on U.S. employment is also unclear. The theoretical effect of income shifting on cross-border investment in the United States is ambiguous, because income shifting may either increase or decrease investment in a high-tax country. Empirical studies show that foreign direct investment depends negatively on a country's corporate tax rate. Relatively high U.S. corporate tax rates,

thus, likely decrease foreign investment in the United States. However, existing studies do not address the question of how income shifting affects cross-border investment. The level of investment by multinationals is unlikely to affect total employment significantly in the United States, unless there is unemployment in the markets for labor whose skills foreign investors demand.

K. Recommendations to Improve Earnings Stripping Provisions

In the last five years, a number of proposals to tighten the rules of section 163(j) have been suggested. The findings of this study provide a fresh opportunity to examine these proposals. Consequently, in light of these findings and the Congressional request to provide recommendations based on our conclusions in this study, the Treasury Department analyzed a number of proposals aimed at restricting the ability of FCDCs and ICs to strip income out of the United States. These are discussed in more detail below.

1. Certain Recent Earnings Stripping Proposals

There are three recent and significant legislative proposals regarding earnings stripping. The first of these proposals was included in S. 1637, the "Jumpstart our Business Strength Act" in 2004. This proposal would tighten the current earnings-stripping rules, but only for corporations that entered into certain inversion transactions described in the proposal. With respect to these corporations, the proposal would eliminate the debt-to-equity safe harbor and would reduce the threshold for excess interest expense to 25 percent of adjusted taxable income. The excess limitation threshold would be modified so that 25 percent of adjusted taxable income over a corporation's net interest expense for the year (if any) could be carried forward three years.

After this proposal was made, AJCA enacted section 7874, which provides special rules regarding the taxation of inversion transactions. The adoption of a proposal such as the one proposed in S. 1637 would require some consideration of the need to coordinate the two provisions (e.g., effective dates and the inversion transactions subject to the two rules).

The second recent legislative proposal was S. 1475, the "Promote Growth and Jobs in the USA Act of 2003." The proposal would provide a special exception for any corporation that could be subject to section 163(j) as a result of a related-party guarantee if the taxpayer could establish to the satisfaction of the Secretary of the Treasury that it could borrow a substantially similar amount of money without the guarantee.

The third recent legislative proposal regarding section 163(j) was included in H.R. 5095, the "American Competitiveness Act of 2002." This proposal would strengthen the rules of section 163(j) in several ways, regardless of whether the corporation entered into an inversion transaction. With respect to the interest-disallowance rule, the proposal would eliminate the debt-to-equity safe harbor and would reduce the threshold for excess interest expense from 50 percent to 35 percent of adjusted taxable income. Disallowed interest could be carried over for five years, but excess limitation could not be carried over.

The proposal would also add an additional interest-disallowance rule that would generally disallow related-party interest expense to the extent that the U.S. subsidiaries of

a foreign parent are more highly leveraged than the overall worldwide corporate group. Disallowed interest and excess limitation could not be carried forward. Financial corporations would be treated as a separate sub-group for purpose of the test. The amount of total interest expense disallowed would be the greater of the current-law disallowance rule, as modified, or the additional interest-disallowance rule.

2. President's Budget Proposals

The President's Budget proposal for FY 2004 also contained a proposal to amend section 163(j) in several ways. First, the proposal would replace the existing debt-to-equity safe harbor with a safe harbor based on a series of debt-to-asset ratios in order to make the safe harbor more sensitive to the ability of different types of assets to support debt. Interest would be disallowed only if a corporation's debt exceeds the safe harbor amount so computed. Second, the proposal would reduce the threshold for excess interest expense to 35 percent of adjusted taxable income. Similar to the proposal in H.R. 5095, this proposal would add a new disallowance provision based on a comparison of domestic and worldwide indebtedness, and the amount of interest disallowed would be the greater of the amounts disallowed under the present-law rule, as modified, or the new disallowance rule. Third, the proposal would limit the carryover of any disallowed interest to five years and would allow no carryover of interest disallowed under the domestic-worldwide indebtedness test. The proposal would eliminate the carryover of excess limitation.

Each of the President's Budget proposals for FY 2005 through FY 2008 contained the same modified section 163(j) proposal. The debt-to-equity safe harbor would be eliminated. The adjusted taxable income threshold for the limitation would be reduced from 50 percent to 25 percent of adjusted taxable income (as opposed to the 35 percent limit in the 2004 proposal) with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee. Interest on guaranteed debt generally would be subject to the current law 50 percent of adjusted taxable income threshold. The carryforward for disallowed interest would be limited to 10 years, and the carryforward of excess limitation would be eliminated.

3. Additional Proposals

The Staff of the Joint Committee on Taxation in its report entitled "Additional Options to Improve Tax Compliance" proposed a change to the reporting required with respect to section 163(j).[39] The proposal would require a taxpayer to report to the IRS whether any portion of its interest deduction is disallowed for the taxable year under section 163(j). If any part of the taxpayer's deduction is disallowed, the taxpayer would also be required to report its computation of how much disqualified interest was paid or accrued during the taxable year, the payees of such interest, and the amount of disqualified interest carried forward.

[39]Joint Committee on Taxation (2006).

4. Analysis and Recommendation

Proposals Limited to ICs

The proposals described above generally would limit corporations' ability to engage in earnings stripping through related-party debt by tightening the rules of section 163(j). Most of them would apply to all FCDCs. One of these proposals, S. 1637, would tighten the rules of section 163(j) only with respect to ICs as described in the provision.

Proponents of rules like those found in S. 1637 often argue that there is no evidence of earnings stripping outside the context of ICs and, consequently, if there is any need to strengthen the rules of section 163(j), these amendments should apply only to corporations that have engaged in inversion transactions. In fact, this study was unable to quantify accurately the extent of earnings stripping by FCDCs, but did find strong evidence that ICs are stripping a significant amount of earnings out of their U.S. operations. Proponents of such a proposal may assert that this study supports their view.

It should be kept in mind that this study does not determine that FCDCs were not stripping. It simply could not be determined that they were, and that may be explained, in part, by the additional difficulty of showing stripping by FCDCs relative to ICs. With respect to ICs, there is an event study comparing an IC's earnings in the United States before and after the event of inverting. Consequently, it is far easier to determine that these ICs are stripping. In contrast, with respect to FCDCs there is no single event for which the comparison of the earnings of the U.S. operations before and after is instructive. Thus, it is only possible to examine the earnings of FCDCs over time in the United States and relative to DCCs. These earnings have declined over time and are lower than the earnings of DCCs. However, this is not conclusive evidence of earnings stripping.

In addition, to the extent that section 163(j) provides opportunities for earnings stripping, these opportunities are not limited to inversion transactions. These opportunities are present in cases where a U.S. business is structured from the outset with a foreign parent and in cases where a foreign corporation acquires a U.S. operating group. In fact, there does not appear to be any mention of a difference in the ability to satisfy the requirements of section 163(j) by ICs relative to FCDCs in the literature or articulated by proponents of a proposal such as S. 1637.

Debt to Equity Safe Harbor

Many of the proposals would eliminate the debt-to-equity safe harbor. Seida and Wempe (2004) state that all four ICs they studied in detail appeared to be within the debt-to-equity safe harbor. It is not clear how this is accomplished. Commentators have noted, however, that many U.S. corporations have debt-to-equity ratios that exceed 1.5 to 1. For example, the capital structure of multinational businesses may vary based on their lines of business and what the market will bear with respect to such a business. Consequently, some commentators have argued that the debt-to-equity safe harbor should not be eliminated but should be modified to reflect this reality.

The President's Budget proposal for FY 2004 was an effort to be responsive to such arguments and would replace the existing debt-to-equity safe harbor with a safe

harbor based on a series of debt-to-asset ratios in order to make the safe harbor more sensitive to the ability of different types of assets to support debt. However, some commentators argued that even this proposal was insufficiently sensitive to differences in certain assets' ability to support debt. Other commentators argued that this proposal was unduly complex in its attempt at greater precision.

The President's Budget proposals for FY 2005 through FY 2008 take a simpler approach and eliminate the debt-to-equity safe harbor. The Treasury Department found that modifying the debt-to-equity safe harbor to take into account different levels of leverage supportable by different assets was too complex and that almost any generalization regarding the ability of the assets of a corporation to support debt, even within limited classes of assets, meant that at least some taxpayers would believe the test was insufficiently precise. Given this concern, the Treasury Department determined in this case that the policy goal of simplicity was paramount.

Additional Disallowance Rule

Both H.R. 5095 and the President's Budget proposal for FY 2004 would add an additional interest-disallowance rule that would generally disallow related-party interest expense to the extent that the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group. Interest disallowed under this rule could not be carried forward and excess limitation also could not be carried forward. Financial corporations would be treated as a separate sub-group. The amount of total interest expense disallowed under this provision would be the greater of the current-law disallowance rule, as modified, or the new disallowance rule.

Commentators noted that the additional disallowance rule would add additional complexity to section 163(j). The tracking of foreign assets and debt required in the domestic-to-foreign debt comparison was seen as burdensome and difficult to apply. Given these comments, the Treasury Department determined that the policy goal of simplicity was better served by having only one disallowance rule.

Guaranteed Debt

One of the proposals (the President's Budget proposal for FY 2005 through FY 2008) would apply a different excess-interest-expense threshold for guaranteed debt and one of the proposals (S. 1475) would loosen the rules related to guaranteed debt. Some have argued that guaranteed debt does not increase the likelihood of base erosion as compared with non-guaranteed debt because borrowers typically obtain guarantees to reduce the interest rate on a loan and such interest is paid to an unrelated party. In fact, these commentators, like the proponents of S. 1475, argue that the rules relating to guaranteed debt should be relaxed or eliminated altogether. However, others argue that third-party debt guaranteed by a foreign related party is a close substitute for direct borrowing from that foreign related party, so if the former is restricted less than the latter, the former can be used to circumvent restrictions on the latter. In this view, the rules for guaranteed debt serve as a backstop to the general rules of section 163(j).[40] The Treasury Department believes that guaranteed debt does not raise the same level of concern that

[40]Parent guarantees may enable FCDCs to have a higher level of debt than would normally be possible for a comparable DCC.

related-party debt raises under section 163(j) and, consequently, there is no need to lower the excess-interest-expense threshold for guaranteed debt. However, the Treasury Department continues to study the rules relating to guaranteed debt.

Recommendation

The earnings-stripping study did not find conclusive evidence of earnings stripping from FCDCs that had not inverted. However, there is strong evidence that ICs have engaged in earnings stripping.

The Treasury Department believes that additional information is needed to determine how the Administration's Budget proposal would affect FCDCs that have not inverted and whether modification to the proposal would be appropriate. In order to obtain this additional information and further the administration of section 163(j), a new tax form has been created, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*. Form 8926 solicits information relating to the determination and computation of a corporate taxpayer's section 163(j) limitation, including the determination of the taxpayer's debt-to-equity ratio, net interest expense, adjusted taxable income, excess interest expense, total disqualified interest for the tax year and the amount of interest deduction disallowed under section 163(j), as well as certain information with respect to the related persons receiving disqualified interest.

III. STUDY OF TRANSFER PRICING

A. Introduction

Section 806 of AJCA included the following mandate for a study of current transfer pricing rules:

> The Secretary of the Treasury or the Secretary's delegate shall conduct a study regarding the effectiveness of current transfer pricing rules and compliance efforts in ensuring that cross-border transfers and other related party transactions, particularly transactions involving intangible assets, service contracts, or leases cannot be used improperly to shift income out of the United States. The study shall include a review of the contemporaneous documentation and penalty rules under section 6662 of the Internal Revenue Code of 1986, a review of the regulatory and administrative guidance implementing the principles of section 482 of such Code to transactions involving intangible property and services and to cost sharing arrangements, and an examination of whether increased disclosure of cross-border transactions should be required. The study shall set forth specific recommendations to address all abuses identified in the study.

To address the issues raised in the statute, this study is comprised of seven sections. Section B contains an executive summary. Section C provides background on transfer pricing compliance under the current regulatory regime. Section D analyzes the adequacy of current rules in providing sufficient, clear, and administrable guidance to taxpayers and the IRS to ensure arm's length results, with particular emphasis on cost sharing arrangements ("CSAs"), services, marketing intangibles, and global dealing transactions.[41] Section E provides an analysis of potential income shifting from non-arm's length transfer pricing under the current regulatory regime, based on tax return data. With Sections C through E as background, Section F provides an overview of recent regulatory guidance by the Treasury Department and the IRS on cost sharing arrangements (proposed), the provision of intercompany services and transfers of intangibles (temporary and proposed), and global dealing transactions (soon to be

[41] "Current regulatory regime," "current rules," "existing rules," and similar references in this study refer primarily to the existing final regulations under Section 482 as of December 31, 2006. These include the 1968 regulations with respect to the intercompany provisions of services under Treas. Reg. § 1.482-2(b), the 1994 transfer pricing regulations under Treas. Reg. § 1.482, the 1996 cost sharing regulations under Treas. Reg. § 1.482-7, and the stock-option regulations under Treas. Reg. §§ 1.482-5 and 1.482-7. For these purposes, the 1998 proposed global dealing regulations are also considered as part of the current regulatory regime. Although these regulations are not in final form, taxpayers and the IRS have significant experience in applying the guidance from the proposed regulations over the past eight years.

reproposed).[42] The study concludes in Section G, and provides recommendations in Section H.

B. Executive Summary

The IRS previously submitted to Congress two major studies, each containing detailed analyses of issues bearing on the administration of section 482 and the applicable regulations, including the transfer pricing penalty provisions. The first of these studies was completed in 1999,[43] and the more recent in 2001.[44] These reports provided the history of section 482 and a description of the regulations under sections 482 and 6662, as well as a review of the administration of those regulations. In the time since those reports were issued, final regulations have been promulgated under §1.482-5 and §1.482-7. The regulations clarify that participants in cost sharing arrangements are required to include compensatory employee stock options within the pool of costs to be shared.[45] The regulations further clarify the appropriate treatment of compensatory employee stock options consistent with the reliability and comparability standards.[46]

With respect to administration of section 482, the fundamental components of the five-part strategy to improve the administration of section 482 described in the 1999 report have remained largely unchanged, although they have been adapted by the IRS to reflect the increased amount and complexity of cross-border activity since that time. The IRS has undertaken several examination initiatives, including emphasizing identification and explanation of book-tax differences, reducing examination cycle time, expanding opportunities for pre-filing compliance, and emphasizing early issue identification and risk assessment. In addition, the IRS has established cross-functional Issue Management Teams ("IMTs"), which provide executive oversight and ensure that resources are allocated to specific cases and issues that pose the highest compliance risk. Also, the IRS Office of Chief Counsel continues to provide support for the initiatives to improve compliance with section 482.

With respect to transfer pricing litigation, the only recent transfer pricing case designated by the IRS Office of Chief Counsel as involving issues of broad significance to the administration of the tax law (that is, a case not to be settled or compromised prior to a final adjudication by the Tax Court) was *Xilinx, Inc. v. Commissioner*. *Xilinx* is currently on appeal to the Ninth Circuit, and the case involves the issue of whether participants in a qualified cost sharing arrangement are required to include compensatory employee stock options within the pool of costs to be shared.[47]

Additionally, the IRS recently resolved a major transfer pricing dispute with Glaxo SmithKline Holdings (Americas) Inc. ("Glaxo"). Glaxo's $3.4 billion payment is the largest single payment ever made to the IRS to resolve a tax dispute.

---

[42]Unless expressly differentiated, references to the Treasury Department in chapter III incorporate the IRS.
[43]"Report on the Application and Administration of Section 482," issued on April 21, 1999.
[44] "Effectiveness of Internal Revenue Code Section 6662(e)," issued on December 28, 2001.
[45]Treas. Reg. § 1.482-7.
[46]Treas. Reg. §§ 1.482-5 and 1.482-1.
[47]*Xilinx* involves taxable years prior to the final regulations under Treas. Reg. § 1.482-7 that clarify that participants in cost sharing arrangements must include compensatory employee stock options within the pool of costs to be shared.

Notwithstanding the marked improvement of the current transfer pricing rules and compliance efforts since 1986, there are certain aspects of the final regulations that may not be sufficiently clear, complete, or effective. These include the rules for cost sharing arrangements, intercompany services, marketing intangibles, and global financial dealings.

Experience in the administration of cost sharing arrangements under Treas. Reg. § 1.482-7 has demonstrated the need for additional regulatory guidance to improve compliance with, and administration of, the cost sharing rules. In particular, there is a need for additional guidance regarding the external contributions for which arm's length consideration must be provided as a condition to entering into a cost sharing arrangement (i.e., what the existing regulations refer to as the "buy-in" payment). Under the current regulations, taxpayers have undertaken valuations that purport to be consistent with the transfer pricing regulations but that the IRS believes to result in systematic undervaluation of buy-in payments. For example, some applications of the "residual profit split method" effectively treat future cost sharing payments as intangible contributions, which allows pure financing participants to earn anticipated returns from the cost sharing arrangement that are in excess of what a similarly situated participant could anticipate earning at arm's length.[48] Not surprisingly, the buy-in provisions have led to many significant high-dollar disputes between taxpayers and the IRS. Additional guidance is necessary to value buy-in payments appropriately, to define more clearly what constitutes a cost sharing arrangement, and to specify more clearly how the commensurate with income standard applies to such arrangements.

The transfer pricing regulations applicable to services were originally promulgated in 1968 and have remained in force, essentially unchanged, for almost 40 years. These regulations have proven to be inadequate to handle the increased volume and complexity of multinational operations and transactions that have occurred since that time. Prior to 2007, the absence of updated services regulations led to discontinuities between transfer pricing for services and transfer pricing for tangible and intangible property. Transfer pricing for tangible and intangible property is addressed in the otherwise comprehensive regulations under section 482 that were promulgated in 1994.

With respect to the development of an affiliate's intangible property, such as marketing services provided by a licensee of a trademark that enhance the value of that trademark, the existing final regulations in certain cases deem the service provider to be the owner of the intangible property for purposes of section 482 and determine the appropriate return to the service provider based on its ownership of such property. This rule may be misapplied to reach "all or nothing" results based on a binary determination of ownership. Instead, as a matter of policy, the income attributable to an intangible should be allocated among controlled taxpayers under the arm's length standard, in accordance with each party's contributions to the development or enhancement of that intangible and its ownership interests.

The proposed global dealing regulations are almost 10 years old and have not yet been finalized. Current law generally provides that securities dealing income and associated expense of a global securities dealing operation are allocated and sourced on

[48]Treas. Reg. § 1.482-6.

an all-or-nothing basis and treated as effectively or non-effectively connected income, depending upon whether a taxpayer is engaged in the conduct of a trade or business in the United States, and whether a securities dealing asset is held in connection with such trade or business or the trade or business is a material factor in the realization of the income. Furthermore, technological advances, increased globalization, and increased interconnection of economic activities have highlighted the need for updated guidance in this area. The 1998 global dealing rules do not yet take account of arm's length interest expense allocations that have since been addressed in some of the United States' more recent treaty agreements. Accordingly, revised regulations are needed to refine the treatments for arm's length sourcing and allocations of income and expenses among participants in a global dealing enterprise.

Based on the Treasury Department's experience administering the current transfer pricing regulations discussed above, this study concludes that there remains some potential for income shifting from non-arm's length transfer pricing. This potential is perhaps most acute with respect to cost sharing arrangements, but is also possible with respect to the provision of intercompany services and other transactions.

The economics literature has historically found empirical evidence that is consistent with income-shifting behavior of multinational groups. The literature shows, for example, that pre-tax profitability of CFCs has been negatively correlated with local country statutory tax rates, taking into account real economic factors such as financial structure, capital employed, and other non-transfer pricing operational aspects of multinational groups. While the data and analyses do not provide direct evidence of specific transfer pricing manipulation (since the data are at a more aggregated level than the necessarily detailed transactional level required to isolate specific transfer pricing effects), they generally do not allay the concerns about potential non-arm's length income shifting derived from a critical assessment of the current transfer pricing regulations. A recent working paper by the Treasury Department's Office of Tax Analysis has attempted to isolate further specific effects of transfer pricing by removing the effects of possible "income stripping" through intercompany debt and by incorporating proprietary data on cost sharing arrangements. Although substantial caution is required in interpreting the specific implications with respect to transfer pricing from the analysis, it shows that the data are consistent with (although not proof of) the existence of potential income shifting from non-arm's length transfer pricing. In addition, the results suggest that CFCs whose parents engage in cost sharing arrangements tend to show more evidence of potential income shifting, but it is unclear the extent to which this may be due to cost sharing arrangements themselves or to other factors.

In response to these developments, a number of regulatory projects have been undertaken: proposed cost sharing regulations (2005); regulations addressing cross-border services (proposed 2003, temporary and proposed 2006); and reproposed global dealing regulations expected to be issued shortly.

Cost sharing represents an area that provides substantial opportunities to shift significant amounts of income out of the United States. The 2005 proposed cost sharing regulations provide a comprehensive revision of the 1996 regulations, and clarify how the arm's length principle is properly applied to these arrangements. The proposed regulations adopt as a fundamental concept an "investor model" for addressing the

relationships and contributions of controlled participants in a cost sharing arrangement. Specific methods for determining the arm's length compensation for external contributions (i.e., the buy-in) are derived from the investor model. The proposed regulations also identify general principles governing all methods, specified and unspecified. The proposed regulations further provide greater clarity on how the "commensurate with income" standard is to be applied to cost sharing arrangements. The proposed regulations provide significantly stronger documentation requirements than those under the existing final regulations. Finally, the proposed regulations provide enhanced definitional clarity to the structure and parameters of cost sharing arrangements. Taken together, the guidance provided by the proposed regulations helps to address the serious problems, particularly relating to buy-in valuations, identified by the Treasury Department.

The 2006 temporary and proposed services regulations generally provide that the "arm's length charge in a services" transaction must be determined by using one of the transfer pricing methods authorized in the regulations. The guidance on methods is generally consistent with the 1994 final regulations (applicable to transfers of tangible and intangible property), and is consistent with international standards with respect to services transactions. The temporary and proposed regulations provide new transfer pricing rules for low-value services, such as routine back-office services. This "Services Cost Method" (SCM) preserves the constructive aspects of the cost safe harbor under Treas. Reg. § 1.482-2(b) (which provides reduced compliance burdens for low-margin services), while eliminating various problematic features. The temporary and proposed regulations also provide guidance intended to coordinate and harmonize the rules applicable to services related to intangibles with the rules applicable to transfers of intangible property. One purpose of the regulations is to ensure that transfer pricing rules, when applied to economically similar transactions, reach substantially similar results. Finally, the temporary and proposed regulations also provide rules and examples regarding the treatment of services performed in connection with the development or enhancement of an affiliate's intangible property, particularly in the context of the development of marketing intangibles. These rules provide for the appropriate economic compensation for such services without the need to impute shifts of ownership of intangible property to service providers, as is done under the current regulations.

The new reproposed global dealing regulations will respond to technological advances, increased globalization, and increased interconnection of economic activities since the global dealing regulations were first proposed in 1998. The reproposed global dealing regulations will be consistent with the approach increasingly adopted by other countries on profit attribution for global dealing operations.[49] The reproposed regulations will also provide rules for determining the source of income earned in a global dealing operation and the circumstances under which such income is effectively connected to a foreign corporation's U.S. trade or business.

Based on this assessment of the effectiveness of current transfer pricing rules and compliance efforts, this study concludes that top priority in this area should be given to the prompt finalization and implementation of the three transfer pricing regulatory

[49]See, e.g., the 2006 OECD *Report on the Attribution of Profits to Permanent Establishments*.

projects discussed above. Substantial and continuous efforts are underway by the Treasury Department to conclude this regulatory process in the near term. When fully effective, these regulations will address known gaps in transfer pricing administration, and will eliminate some of the known avenues for non-arm's length income shifting available to multinational groups.

While enhanced disclosure is generally helpful from a tax administration standpoint, the Treasury Department is cognizant of the burden already faced by companies in complying with admittedly complex transfer pricing rules. In fact, an important part of each of the regulatory projects has been specifying documentation and information requirements that allow for proper administration of the regulations with the least possible burden to taxpayers. Given the current disclosure requirements already in place (as well as the additional disclosure requirements in the various temporary and proposed regulations discussed above), the generally high audit rates of affected taxpayers, and the enhanced ability of the U.S. Competent Authority to exchange information with other tax jurisdictions, we do not recommend additional disclosure requirements at this time.

C. Background

1. Introduction

The IRS previously submitted to Congress two major studies, each containing detailed analysis of issues bearing on the administration of section 482 and the applicable regulations, including the transfer pricing penalty provisions. The first of these studies was completed in 1999, the more recent in 2001. This section briefly summarizes these studies. It then provides an update concerning recent developments and new initiatives that the IRS has adopted to deal with the rapidly evolving compliance environment applicable to multinational groups, with emphasis on developments and initiatives relevant to transfer pricing.

2. Review of Recent IRS Studies on Transfer Pricing Compliance

1999 Report on the Administration of Section 482

On April 21, 1999, the IRS issued its "Report on the Application and Administration of Section 482" (the "1999 Report").[50] This report was prepared in accordance with a directive in the Conference Report to H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999.[51] This directive called for the IRS to review and report to Congress concerning the administration of section 482.

The 1999 Report observed that, historically, the primary obstacle to effective administration of section 482 had been the failure of taxpayers to make efforts to comply with the arm's length standard under section 482 prior to or contemporaneously with the filing of the income tax return for the year in question. Moreover, even when taxpayers undertook to comply on a contemporaneous basis, they seldom prepared documentation describing the controlled transactions or the transfer pricing methodology used to

[50] IRS Publication 3218 (4-1999). Cat. Number 26802E.
[51] Pub. L. 105-277, 105th Cong., 2d Sess. 1486 (1998).

determine taxable income. As a result of the lack of even basic information, IRS examiners were often required to analyze the taxpayer's transfer pricing without the knowledge of any underlying facts. Because transfer pricing involves detailed factual analysis, even an examination that involved relatively straightforward transfer pricing issues could take several years to complete.

Against this historical backdrop, the 1999 Report described several statutory and regulatory amendments and other initiatives that had been adopted to address these fundamental problems. The aim of these initiatives was to redirect the primary focus of transfer pricing compliance away from after-the-fact examination and litigation of transfer pricing controversies (as described in the preceding paragraph), in the direction of upfront taxpayer compliance, including, to the extent possible, advance resolution of transfer pricing issues. The 1999 Report noted that the IRS intended to follow a five-part strategy to improve the administration of section 482. This strategy consisted of issuing additional guidance under section 482, encouraging upfront compliance on the part of taxpayers, building international consensus concerning transfer pricing issues, resolving contentious transfer pricing cases by means of Advance Pricing Agreements ("APAs"), and, where appropriate, pursuing strategic section 482 litigation. To a large degree, many elements of the strategy were seen as mutually reinforcing. For example, the IRS indicated its willingness to negotiate in good faith to resolve disputed transfer pricing cases, either in the APA program or by other avenues of alternate dispute resolution, such as IRS Appeals. However, where it is not possible to resolve transfer pricing cases in such a manner, it is necessary for the IRS to be prepared to defend its position by means of litigation.

2001 Report on the Effectiveness of Section 6662(e)

On December 28, 2001, the IRS Director, International[52] issued a report entitled "Effectiveness of Internal Revenue Code Section 6662(e)" (the "2001 Report").[53] This report responded to concerns raised by the Senate Committee on Appropriations regarding the effectiveness of certain statutory provisions intended to facilitate administration of section 482, in particular section 6662(e).[54] The Committee directed the IRS to analyze the impact of section 6662(e) on transfer pricing compliance, and sought information on three specific areas: (1) whether taxpayers are preparing contemporaneous transfer pricing documentation, as anticipated by section 6662(e); (2) the quality of the documentation; and (3) the utility of such documentation to the IRS in enforcing section 482.

The 2001 Report concluded that IRS administration of section 482 was facilitated when IRS examiners had access to contemporaneous documentation that described the methodology used by the taxpayer to apply the arm's length standard. When documentation was generated by taxpayers and analyzed by the IRS, it tended to increase the overall efficiency of the examination, because it was possible to identify key transfer

---

[52]Under the IRS' current organizational structure, the position of Director, International corresponds to the Deputy Commissioner, Large and Midsize Business (International).

[53]Fiscal Years 2000-2001 IRS Study: Effectiveness of Internal Revenue Code Section 6662(e) (December 28, 2001).

[54]See Report No. 106-87 to the Treasury and General Government Appropriation Bill, 2000 (S. 1298, 106th Congress, 1st Sess.).

pricing issues early in the process. Early identification of issues allowed the IRS to concentrate examination resources on those controlled transactions that raised the most substantial issues. The report also noted that the quality of this documentation varied widely from one taxpayer to another.

Recent Developments

The fundamental components of the five-part strategy to improve the administration of section 482 described in the 1999 Report have remained largely unchanged, although they have been adapted by the IRS to a new compliance environment. Specifically, the IRS continues to (1) issue additional guidance under section 482, (2) encourage upfront compliance on the part of taxpayers, (3) build international consensus concerning transfer pricing issues, (4) resolve contentious transfer pricing cases by means of APAs, and (5) where appropriate, pursue strategic section 482 litigation. This subsection addresses recent developments relevant to the administration of section 482 by the IRS.

Section 482 Guidance

A major focus of activity in this area is publication of guidance concerning application of the arm's length standard under section 482. The goal is to continue to refine the transfer pricing regulations and to provide guidance that supplies direction to taxpayers and IRS personnel concerning the arm's length standard.

Since the release of the 1999 Report and the 2001 Report, final regulations have been issued with respect to the comparable profits method and on cost sharing arrangements and the treatment of compensatory stock options.[55] With respect to the comparable-profits method, the regulations clarify that comparability may be affected by, and should be adjusted for, material differences in the utilization of or accounting for stock options between the tested party and comparable parties. With respect to cost sharing arrangements, the regulations address the treatment of stock-based compensation under a qualified cost sharing arrangement ("QCSA") and the interaction between the rules applicable to QCSAs and the arm's length standard. The regulations provide that stock-based compensation related to the covered intangible development area must be taken into account in determining the costs to be shared by participants in a QCSA. For stock-based compensation in the form of options on publicly traded stock, the controlled participants may elect to have the valuation and timing reflect the charge against income in audited financial statements or footnotes. In other cases, the expense attributable to stock-based compensation is the amount allowable as a federal income tax deduction on exercise. This amount generally is the "spread" between the option price and the fair market value of the underlying stock at the date of exercise.

The Treasury Department has recently issued or is in the process of issuing several major items of substantive guidance in the section 482 area. These items are described in detail in Section F of this study.

[55]Treas. Reg. §§ 1.482-5 and 1.482-7.

Examination Initiatives and Programs

Major initiatives recently undertaken by the IRS include emphasizing identification and explanation of book-tax differences, reducing IRS examination cycle time, expanding opportunities for pre-filing compliance, and emphasizing early issue identification and risk assessment. In addition, the IRS has established cross-functional Issue Management Teams ("IMTs"), which provide executive oversight and ensure that resources are allocated to specific cases and issues that pose the highest compliance risk.

The Compliance Assurance Process ("CAP") is a compliance review approach that allows the IRS to determine tax return accuracy before the tax return is filed. Under this process, the IRS engages the taxpayer during the tax year to facilitate the identification, review, analysis, and resolution of material tax issues involving completed transactions. The IRS then seeks the filing of compliant returns for the year in question, and ensures that appropriate IRS enforcement actions are taken, including traditional examination processes, as appropriate. The process is intended to build on corporate-governance requirements and on the financial-accounting model of real-time resolution of material issues. As compared to traditional post-filing examination processes, CAP can provide a taxpayer more certainty concerning its tax liability for a given year within months, rather than years, of filing a tax return. This program should reduce taxpayers' compliance burden and the need to book income tax reserves, while also reducing cycle time for IRS examinations and allowing for more efficient use of IRS resources. Similar initiatives involve the Limited Issue Focused Examination ("LIFE") program, which focuses resources on a limited number of critical issues that are identified at the outset of the examination, and the Prefiling Agreement ("PFA") program, which allows taxpayers to obtain advance agreement on matters likely to be disputed in connection with returns for one or more taxable years.

The first IMT in the transfer pricing area concerns cost sharing, but also applies to transfers and licenses of intangibles more broadly. This IMT is intended to improve the IRS' ability to identify, develop, and resolve issues in this key compliance area. Under the auspices of the IMT, a Cost Sharing Audit Checklist was issued in 2005 to provide guidance to IRS examiners. In 2007, the IMT released a coordinated issue paper ("CIP") that will increase the uniformity of IRS examinations of cost sharing issues. The CIP provides guidance to IRS personnel concerning the methods that may be applied to evaluate the arm's length charge for pre-existing intangible property that is made available, for purposes of research, to a QSCA.

The second transfer pricing IMT involves section 936 termination cases. Concerns in this area arise from actions taken by taxpayers in response to the elimination, at the end of 2006, of tax benefits under section 936 for qualifying Puerto Rican operations. Certain claimants of section 936 benefits have transferred U.S.-owned intangibles, which were previously used in Puerto Rican operations, to a new subsidiary, often domiciled in a low-tax jurisdiction. The taxpayer then enters into a series of controlled transactions with the new subsidiary (often including a license of intangibles), the effect of which is that the new subsidiary earns very substantial profits. These cases raise substantial issues concerning the appropriateness of transfer pricing between the U.S. corporation and the new subsidiary, as well as the amounts that may be due under

section 367(d), a provision that applies to outbound transfers of intangibles in what otherwise qualifies as a tax-free reorganization.

With respect to documentation efforts, in January 2003, the Commissioner, Large and Midsize Business ("LMSB"), issued a Compliance Memorandum restating the importance of issuing requests for section 6662(e) transfer pricing documentation. In 2005, the LMSB Commissioner issued another memorandum that requires IRS examiners to request and review taxpayer transfer pricing studies in all cases that involve cross-border controlled transactions that are material in amount or volume. This effort should allow IRS examiners and their managers to determine whether in-depth examination of transfer pricing issues is warranted, thereby allowing material section 482 issues to be pursued as appropriate.

Another initiative is the Outside Expert Program ("OEP"), which complements the in-house expertise of IRS transfer pricing economists. Under the OEP, the IRS has retained several independent economic experts to serve on an ad hoc basis as consultants on cost sharing cases. These experts provide technical assistance as requested to a specific IRS examination team, in support of IRS economists.

A final initiative involves training of agents and managers concerning proper use of the LIFE model (described above), as well as a new risk assessment tool that is in development. The LIFE model, combined with refined examination standards and quality criteria, allows IRS examiners and managers to focus on the most significant issues in a particular examination. It is anticipated that training on the use of the risk assessment tool will include, among other items, consideration of transfer pricing issues.

Activities by the Office of Chief Counsel

The Office of Chief Counsel provides support for the initiatives to improve compliance with section 482. Within the Office of Chief Counsel, the Associate Chief Counsel (International) has primary responsibility for issues involving section 482 in the cross-border context. Branch 6 in the Office of the Associate Chief Counsel (International) ("ACC(I)") has subject-matter jurisdiction over technical issues under section 482. The APA Program, which is also located within ACC(I), negotiates and executes Advance Pricing Agreements with taxpayers. ACC(I) attorneys participate in drafting published guidance within their subject-matter jurisdiction and provide a full range of technical assistance to IRS functions, including Examination, Appeals, and Competent Authority.[56] ACC(I) attorneys also provide technical assistance to attorneys in LMSB Counsel and Small Business/Self Employed ("SBSE") Counsel who are engaged in transfer pricing litigation in the U.S. Tax Court.

In providing assistance on section 482 issues, ACC(I) and LMSB Counsel follow a "team" approach, based on requests for assistance, primarily from LMSB examiners. Although the examiners are responsible for factual development in connection with these issues, one or both Counsel may provide ongoing assistance over the course of an examination. Counsel may also advise examiners on interacting with other IRS

[56]The term "Competent Authority" refers to the government official designated to enter into binding agreements on behalf of a revenue authority concerning the application of one or more provisions of an income tax treaty. Under U.S. practice, the Competent Authority is the Deputy Commissioner, Large and Midsize Business (International).

functions, including the International Technical Advisors for section 482 or IRS economists.

APA Program

The APA Program continues to constitute a critical component of the effective enforcement of section 482. The APA program provides an alternative means of resolving difficult transfer pricing issues without resort to litigation. Under the APA program, the IRS and the taxpayer come together in a voluntary, cooperative effort to reach a binding agreement concerning prospective application of section 482 to one or more specified controlled transactions, referred to as "covered transactions." In some circumstances, the methodology agreed to in the APA may also be "rolled back," for purposes of resolving one or more taxable years for which the statute of limitations remains open.

Multilateral Efforts

The Treasury Department has worked through the OECD to build a consensus on the application of the arm's length principle. The most notable product of this effort was the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises ("1995 Transfer Pricing Guidelines").[57] Working Party No. 6 of the OECD Committee on Fiscal Affairs considers a wide range of issues related to transfer pricing, including both technical and policy issues. Pending items on the agenda of the Working Party include a comprehensive review of comparability and a review of the status of the so-called profit methods (the "transactional net margin" method and the "residual profit split" method) under the 1995 Transfer Pricing Guidelines. When completed, these projects may lead to proposed amendments or supplements to the 1995 Transfer Pricing Guidelines. The Working Party is also nearing finalization of a major, multi-year project that involves applying the 1995 Transfer Pricing Guidelines, by analogy, to attribute profits to a permanent establishment, under Article 7 of the OECD Model Tax Convention on Income and on Capital.[58] When finally adopted by the Committee on Fiscal Affairs, the conclusions of this work program may be implemented by changes to the text of Article 7, the associated Commentary on Article 7, and potentially other provisions of the OECD Model Tax Convention and Commentary as well.

The Treasury Department also seeks to develop consensus in multilateral organizations other than the OECD. For example, in March 2003, the IRS announced that it had reached an agreement with other members of the Pacific Association of Tax Administrators ("PATA"). The agreement set forth principles allowing taxpayers to prepare a single set of transfer pricing documentation that would satisfy the provisions of each PATA member country. The PATA Documentation Package was negotiated in response to complaints by business groups that by adopting non-uniform documentation provisions, major trading nations had greatly increased compliance costs.

---

[57]Organisation for Economic Co-Operation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; July 1995.

[58]Organisation for Economic Co-Operation and Development, "Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks), and III (Global Trading)". Centre for Tax Policy and Administration; December 2006.

IRS Office of Appeals

Appeals is an independent function within the IRS that attempts to resolve cases that would otherwise be litigated. A significant portion of cases involving section 482 adjustments are successfully resolved in the course of the examination. However, many cases involving section 482 adjustments are referred to Appeals. When taxpayers do not agree with an audit adjustment, they may file a protest with Appeals regarding the adjustment. An Appeals Officer or an Appeals Team will evaluate the facts and circumstances surrounding the tax issues and attempt to resolve the case. Except where an Appeals Settlement Guideline or other provision applies, the Appeals Officer has plenary authority to resolve the dispute in the manner he or she deems appropriate.

Mutual Agreement Procedures

The procedures by which U.S. taxpayers may request assistance from the U.S. Competent Authority were revised and updated in 2006.[59] Taxpayers may request the assistance of the U.S. Competent Authority for relief from double taxation by means of a dispute-resolution process called the Mutual Agreement Procedure ("MAP"). In a MAP, the competent authorities of the United States and the treaty partner meet to seek mutual agreement concerning difficulties or doubts concerning the interpretation or application of a tax treaty. In the case of transfer pricing issues, the MAP generally concerns the application of the arm's length principle, as reflected in Article 9 of most U.S. tax treaties, by the United States or the treaty partner.

Because a MAP involves a negotiation between treaty partners, the final outcome is uncertain. One country may agree that the other country's application of the arm's length principle is acceptable, in which case it may cede jurisdiction to tax the income in question. In that case, double taxation is avoided. A partial agreement is also possible, in which case double taxation may be reduced but not eliminated. Finally, the treaty partners may be unable to reach agreement, in which case partial or complete double taxation may result. As part of the MAP, the treaty partners often consider other matters ancillary to the final resolution, such as the effect of refund of taxes on foreign tax credits, conforming adjustments required on account of the agreed transfer pricing adjustments, repatriation of funds, and other matters.

A substantial portion of the inventory of the U.S. Competent Authority consists of cases that involve transfer pricing adjustments. In recent years, as foreign revenue authorities have devoted additional resources to transfer pricing matters, the number of foreign-initiated adjustments to foreign affiliates of U.S. taxpayers has increased substantially. The U.S. Competent Authority has pursued with U.S. treaty partners various means to reduce the overall backlog of cases and the number of cases that cannot be resolved in a manner that eliminates double taxation. For example, in 2004, the U.S. Competent Authority entered into a Memorandum of Understanding with the Canadian Competent Authority to resolve factual disputes that prevent resolution of pending MAPs between the two countries.

If a section 482 adjustment by the IRS creates a potential for double taxation (i.e., taxation of the same item of income by both the United States and another country),

[59]Rev. Proc. 2006-54, 2006-49 I.R.B. 1035.

taxpayers may seek competent authority relief in addition to consideration by the IRS Office of Appeals ("Appeals"). Taxpayers may request either simultaneous or sequential review on the part of Appeals and the U.S. Competent Authority.[60] Under the simultaneous procedure, Appeals participates in the competent authority process, although the Competent Authority has responsibility for preparing and presenting the negotiating position to the treaty partner. Under the sequential procedure, taxpayers may request initial consideration of the case by Appeals. If a taxpayer reaches a settlement on the issue with Appeals, the U.S. Competent Authority will seek only to obtain correlative relief from the treaty partner; it will not engage in substantive negotiations with the treaty partner, which could have the effect of reconsidering the merits of the Appeals resolution.

Litigation of Transfer Pricing Controversies

The final significant component of transfer pricing administration is litigation. Because the majority of section 482 disputes are resolved in the course of the IRS examination, or based on consideration by Appeals, relatively few disputes involving transfer pricing result in issuance of a statutory notice of deficiency, which is the legal demand for payment of additional tax. The issuance of such a notice gives rise to jurisdiction for filing by the taxpayer of a petition in U.S. Tax Court, or for payment of tax and filing of a claim for refund in U.S. District Court or the U.S. Court of Federal Claims. In the case of petitions in Tax Court, the IRS Counsel from the specific division that issued the notice generally defends the case in Tax Court. District Court and Court of Federal Claims refund actions are defended by attorneys of the Department of Justice, Tax Division.

Transfer pricing litigation is often very resource-intensive, given that it usually involves a large factual record, submission of expert testimony on specialized matters, and economic and other analysis needed to support the IRS adjustment under the applicable standard of review. Substantial work generally must be performed in addition to the development and analysis done in the IRS examination. The precedential value of a decision involving section 482 may be quite limited, due to the highly factual nature of most disputes. Nonetheless, the IRS devotes substantial resources to litigation in this area.

The 1999 Report contained a comprehensive review of litigation involving transfer pricing cases. In the years since the issuance of that report, the IRS has continued to litigate a number of similar cases, as a component of its overall strategy with respect to the enforcement of section 482. Cases defended by the IRS Office of Chief Counsel fall into three basic categories: (1) general litigation, (2) notice cases, and (3) designated cases. All of these cases involve similar resources on the part of LMSB Counsel, but notice cases and designated cases involve coordinated issues or other matters and call for more extensive involvement by Associate Offices of IRS Chief Counsel, generally ACC(I).

Notice cases involve an issue of substantial or widespread importance, on which coordination with subject-matter experts in the relevant Associate Office of the IRS Chief Counsel is deemed advisable. Designated cases are "designated" for litigation because

[60]See Rev. Proc. 2006-54, 2006-49 I.R.B. 1035, §§ 7, 8.

they involve issues of broad significance to the administration of the tax law, which may not be settled or compromised prior to a final adjudication by the Tax Court. To date, the only transfer pricing case to be designated is *Xilinx, Inc. v. Commissioner*, which involves the issue of whether participants in a qualified cost sharing arrangement are required to include compensatory employee stock options within the pool of costs to be shared.

The following matters involve significant issues under section 482 that have been resolved in, or are pending in, U.S. Tax Court:

H Group Holding, Inc. v. Commissioner, T.C. Memo. 1999-334;

Adaptec, Inc. v. Commissioner, Docket Nos. 10077-00, 3480-01 ;

BIB USA, Inc. v. Commissioner, Docket No. 4434-03;

BMC Software v. Commissioner, Docket No. 2671-00;

Compaq Computer Corp. v. Commissioner, T.C. Memo 1999-220;

Dart Container Corp. v. Commissioner, Docket No. 10526-01;

Glaxo SmithKline Holdings (Americas), Inc. v. Commissioner, Docket No. 5740-04;

Mary Kay Corp. v. Commissioner, Docket No. 18150-02;

Schneider Electric Holdings, Inc. v. Commissioner, Docket No. 12225-02;

United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268, reversed and remanded, 254 F.3d 1014 (11th Cir. 2001), dismissed per stipulation, order entered January 22, 2003;

Veritas Software Corp. v. Commissioner, Docket No. 12075-06;

Xilinx, Inc. v. Commissioner, 125 T.C. 37 (2005), appeals docketed, Nos. 06-74246 and 06-74269 (9th Cir. Sept. 29, 2006).

The IRS recently resolved a major transfer pricing dispute with Glaxo. This case represents the largest single settlement, by dollar value, in the history of the IRS. Under the settlement agreement, Glaxo will pay approximately $3.4 billion to resolve a long-running transfer pricing dispute for the tax years 1989 through 2005.

D. Effectiveness of Current Transfer Pricing Rules and Compliance Efforts

1. Introduction

There have been successes both in providing transfer pricing guidance and in effectively administering transfer pricing rules since the modification to section 482 in 1986. The theoretical underpinnings of the 1988 Treasury White Paper provided the basis for comprehensive revision of the transfer pricing regulations over the succeeding eight years. Each major regulatory endeavor, including the 1994 section 482 regulations and the 1996 cost sharing regulations, was undertaken with significant input by taxpayers and practitioners. Further, the section 482 regulations were helpful to the work of the OECD in its development of the 1995 Transfer Pricing Guidelines.

The section 482 regulations provide a basis for undertaking transfer pricing analyses that are flexible enough to take into account the facts and circumstances

surrounding particular intercompany transactions, while providing a rigorous and consistent means of assessing arm's length outcomes. The best method rule,[61] based on the functional analysis[62] and applied under the comparability[63] and reliability[64] standards, provides an overall framework under which specific methods can be evaluated. The acceptance of a range, rather than a point, of potential arm's length outcomes is a recognition of the inexact nature of transfer pricing and provides relief to taxpayers facing legitimate uncertainty. Finally, the guidance on specific methods for transfers of tangible and intangible assets and services transactions provides practical guidance that allows taxpayers to apply the arm's length standard. Taken together, the section 482 guidance generally allows for effective self-compliance and effective IRS administration of this critical aspect of tax computations.

2. Inadequate Guidance and Potential Scope for Abuse Under the Current Regulations

Notwithstanding the general effectiveness of the current transfer pricing rules and compliance efforts, there are certain aspects of the existing final regulations that may not be sufficiently clear or complete. These include the treatment of cost sharing arrangements, the treatment of intercompany services, certain rules pertaining to marketing intangibles, and the treatment of global financial dealings.

Cost Sharing Arrangements

The Treasury Department believes that the 1996 cost sharing regulations,[65] when properly applied, place cost sharing arrangements within the arm's length standard, and are consistent with the rest of the section 482 regulations, notably Treas. Reg. § 1.482-1. Nevertheless, experience in the administration of CSAs under the 1996 regulations has demonstrated the need for additional regulatory guidance to improve compliance with, and administration of, the cost sharing rules. In particular, there is a need for additional guidance regarding the scope of the external contributions for which arm's length consideration must be provided as a condition to entering into a CSA. The consideration for this type of external contribution is referred to in the existing regulations as the "buy-in." Furthermore, additional guidance is needed on valuation of buy-in payments. Finally, other technical and procedural issues have arisen in the course of the administration of the cost sharing rules that should be clarified.[66]

---

[61]Every transaction reviewed under section 482 must be evaluated "under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result." Treas. Reg. § 1.482-1(c)(1).

[62]The comparability of controlled and uncontrolled transactions "is based on a functional analysis that identifies and compares the economically significant activities undertaken … by the taxpayers in both controlled and uncontrolled transactions." Treas. Reg. § 1.482-1(d)(3)(i).

[63]"Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances." Treas. Reg. § 1.482-1(d)(1).

[64]Whether a method gives the most reliable measure of an arm's length result depends in part upon the reliability of the assumptions made. Treas. Reg. § 1.482-1(c)(2)(ii).

[65]Treas. Reg. § 1.482-7.

[66]For example, because of the interaction of the rules pertaining to the research credit under section 41 and the cost sharing rules under Treas. Reg. § 1.482-7, a U.S. CSA participant performing research is entitled to

The importance of buy-in payments was recognized in the legislative history of the Tax Reform Act of 1986:

> In order for cost sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. *In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment.*[67]

Under the 1996 cost sharing regulations, the provisions on buy-in payments apply whenever a controlled participant to a CSA makes available for purposes of research its pre-existing intangible property to the other controlled participants. In such a case, the transferring controlled participant of that pre-existing intangible property is treated as having transferred interests in such property to the other controlled participants. Accordingly, the other controlled participants must make buy-in payments to the transferring controlled participant. The cost sharing regulations provide no special valuation guidance on these payments, only that "the buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of Treas. Reg. §§ 1.482-1 and 1.482-4 through 482-6."[68]

The issues that arise under the buy-in provisions generally relate to the nature and scope (and thus the value) of the intangible property rights transferred to a CSA, and the form, structure, and timing of the buy-in payments in exchange for those rights. Although the general nature of rights transferred in a buy-in transaction may be inferred from the regulation language, disputes with taxpayers have arisen concerning which intangibles (or the various rights thereto) are subject to the buy-in, and how they should be valued.

The particularly complex valuation issues that arise under CSAs may indicate that the existing guidance is inadequate. For example, the general section 482 guidance on valuing intangible property typically applies to existing (and thus currently exploitable) technology. In contrast, CSAs typically involve two different types of intangible property. The first type of intangible property is the *envisioned* (that is, not currently existing and, therefore, not currently exploitable) technology that is the very subject of the cost sharing arrangement. The second type of intangible property, the subject of the buy-in payment, is the existing intangible that is contributed by one or more of the cost sharing participants, whose value derives from the intangible's contribution *to the development of the envisioned intangible*, rather than, for example, to the contributed intangible's exploitation in its own right. Further, the second type of intangible property

---

a research credit on its total research expenditures, notwithstanding that the U.S. participant is receiving cost sharing 'reimbursement' from foreign CSA participants.

[67]H.R. Conf. Rep. No. 99-841 at II-638 (1986). (Emphasis added).

[68]Treas. Reg. § 1.482-7(g)(2).

is often an "in-process" intangible that is not currently exploitable and, therefore, particularly difficult to value.

In this complex and uncertain environment, taxpayers have undertaken valuations that purport to be consistent with Treas. Reg. § 1.482-4 through § 1.482-6, but that may result in systematic undervaluation of the buy-in payment, and, thus, produce income shifting from non-arm's length transfer pricing. For example, some applications of the residual profit split method effectively treat future cost sharing payments as intangible contributions, allowing pure financing participants to earn anticipated returns from the CSA that are in excess of what a similarly situated participant could expect to earn at arm's length. In other cases, the buy-in amount is determined by reference to a contingent royalty based on sales of the cost-shared intangible. The stream of contingent royalties is usually due only over what the taxpayer asserts to be the "useful economic life" of the specific intangible property rights acquired in a buy-in transaction. Consequently, that useful life assumption has a significant effect on the buy-in calculation. In some cases, taxpayers have argued that the useful economic life of the contributed intangibles expires before the sales associated with the CSA occur, supporting a result that *no* buy-in payment is ever payable. Such arguments are indicative of potentially systematic non-arm's length pricing of buy-in payments.

The buy-in provisions in the 1996 regulations have led to many significant high-dollar disputes between taxpayers and the IRS. Beyond the valuation issues illustrated above, these disputes involve definitional issues relating to which intangibles are subject to the buy-in provisions, the nature of the interests in the "deemed transfers" that give rise to the buy-in requirement, and many other technical issues. The result has been a significant drain on the resources of taxpayers and the IRS.

The IRS' experience in administering the cost sharing regulations has consequently led the Treasury Department to conclude that additional guidance is necessary to value buy-in payments appropriately, to define more clearly what constitutes a CSA, and to specify more clearly how the commensurate with income standard applies to such arrangements.

With respect to buy-in payments, such guidance should take into account the characteristics of CSAs particularly relevant to buy-in valuations. First, CSAs are, by their very nature, forward looking. As with joint-venture agreements between unrelated parties who agree to pool resources to develop products or markets for mutual future benefit, contractual terms relating to the rights, contributions, and responsibilities of the parties should be established *at the outset* of the arrangement. Second, CSAs involve real risks relating to whether and the extent to which the envisioned intangible will be successfully developed and exploited. The nature of these risks is different from the risks associated with currently exploitable intangible property that is more typically the subject of Treas. Reg. § 1.482-4. Third, after-the-fact valuations of currently exploitable intangibles – typical in valuations outside of CSAs – are a dubious means of valuing contributed intangibles in a CSA. Finally, the research and other rights associated with intangibles contributed to CSAs must be clearly defined and sufficiently broad to measure realistically the full value of the contributed intangibles in developing the envisioned intangibles.

Technically, the "commensurate with income" standard applies to CSAs through the reference in Treas. Reg. § 1.482-7(g) to the general guidance relating to the transfer of intangible property in Treas. Reg. § 1.482-4 through § 1.482-6, which includes the "periodic adjustment" guidance of Treas. Reg. § 1.482-4(f)(2). However, in light of the valuation difficulties discussed above, the regulations do not provide clear guidance on how the periodic adjustments should apply to CSAs. Further, some taxpayers have interpreted section 482 to mean that periodic adjustments are not the sole prerogative of the Commissioner, but instead may be used proactively by the taxpayer to make *ex post* adjustments to buy-in payments (most notably when the CSA turns out to be unsuccessful).

As discussed in Section F, these and other issues are addressed in the recently proposed cost sharing regulations (2005).

Intercompany Services

The existing final transfer pricing regulations applicable to services were issued in 1968. In the interim, services have become an increasingly important component of the United States economy and the global economy. Large, integrated multinational groups are much more common now than they were in 1968, and services rendered within such groups constitute a growing proportion of intra-group transactions. The absence of updated services regulations has led to discontinuities between transfer pricing for services and transfer pricing for tangible and intangible property, which is addressed in the otherwise comprehensive 1994 section 482 regulations.

The 1968 services regulations incorporate a so-called cost safe harbor, which permits certain intra-group services to be compensated at cost, with no profit element. In practice, the cost safe harbor applies to the majority of outbound intra-group services, including some services that may not be within the intent of the original rule. The determination of the arm's length charge depends on whether the services transaction is an "integral part" of the business of the renderer or the recipient, and other subjective tests. Applying the rules has been problematic. In particular, the current final regulations in some cases have been interpreted or applied to reach inappropriate results from a policy perspective by allowing high-margin controlled services to be priced at cost. Further, the qualitative and subjective tests in the current final regulations for determining whether a controlled service may be priced at cost have been difficult to apply and have led to disputes.

Because guidance on intercompany services transactions was not part of the 1994 section 482 regulations, there has been a need to provide guidance concerning selection and application of the appropriate method for pricing intercompany services by more clearly incorporating the general rules in Treas. Reg. § 1.482-1 (including the best method rule of Treas. Reg. § 1.482-1(c), the comparability analysis of Treas. Reg. § 1.482-1(d), and the arm's length range of Treas. Reg. § 1.482-1(e)) of the existing regulations. In addition, there has been a need to coordinate better and harmonize the rules applicable to services transactions with the rules for other types of transactions under section 482, in particular transfers of intangible property. Such guidance is necessary to mitigate the extent to which the form or characterization of a transfer of intangibles as the rendering of services can lead to inappropriate results. In general, the

transfer pricing rules should reach similar results in the case of economically similar transactions, regardless of the characterization or structuring of such transactions.

As discussed in Section F, recent regulatory efforts ultimately resulting in the temporary and proposed services regulations (2006) have addressed these concerns.

Marketing Intangibles

Special rules may apply to services performed in connection with the development or enhancement of an affiliate's intangible property, such as marketing services provided by a licensee of a trademark that enhance the value of that trademark. In certain cases, instead of determining the service provider's income on the basis of an analysis of the service, the regulations deem the service provider to be the owner of the intangible property for section 482 purposes and determine the appropriate return to the service provider based on its ownership of such property. These rules also provide that intangible property may have multiple owners. These rules are illustrated by the so-called "cheese examples" in Treas. Reg. § 1.482-4(f)(3).

Commentators have questioned the use of ownership for purposes of section 482, as distinct from legal ownership or ownership for tax purposes more generally, as an analytical tool for determining the appropriate allocation of income attributable to an intangible. Existing final regulations under Treas. Reg. § 1.482-4(f)(3), when properly applied, generally reach appropriate results in allocating income attributable to intangible property. However, the Treasury Department is concerned that the regulation may be misapplied to reach "all or nothing" results based on a determination of ownership in cases where an arm's length analysis in accordance with the section 482 regulations would require that the income attributable to an intangible be divided among the controlled taxpayers that made significant contributions to develop or enhance that intangible, and that hold legal rights with respect to that intangible.

As a policy matter, the rules for determining the ownership of an intangible generally should be distinct from the rules for determining the allocation of income from an intangible. The income attributable to an intangible should be allocated among controlled taxpayers under the arm's length standard, in accordance with each party's contributions to the development or enhancement of that intangible and its ownership interests (if any). This analysis generally would preclude "all or nothing" results.

As discussed in Section F, these issues have been addressed in the temporary and proposed services regulations (2006).

Global Dealing in Financial Products

Financial institutions have traditionally acted as intermediaries between persons who want to invest capital, and those who need to acquire capital. In addition to brokering the basic capital needs of customers, financial institutions have developed innovative financial products that facilitate shifting varying types of risk, such as interest rate, currency, and credit risk. Institutions also manage their own risk for all jurisdictions and time zones where they conduct trading or dealer operations. Technological advances have enabled financial institutions to supply these products and implement risk-management practices on a 24-hour basis through offices around the world. This practice is commonly referred to as "global trading" or "global dealing."

Existing regulations governing taxation of financial products have not kept pace with the changes in the industry, and their continued application has been criticized as producing uneconomic results. The current final regulations for determining the source and effectively connected treatment of securities dealer income were intended to apply in situations where one location participated in the majority of the earnings process. As a result, current rules do not produce appropriate results in a situation where offices in multiple jurisdictions ordinarily and regularly participate in the earnings process of particular transactions. Accordingly, each jurisdiction's tax laws seek to capture its economic share of income produced. The lack of harmonized rules between jurisdictions increases the likelihood of double taxation.

In 1990, the IRS issued Announcement 90-106, requesting comments on how the regulations under sections 482, 864 and other sections of the Code could be improved to address the taxation issues raised by global trading of financial instruments. Because final regulations were not issued in response to the comments that were received, there remained a number of uncertainties regarding the manner in which the existing regulations apply to financial institutions that deal in financial instruments through one or more entities or trading locations. Many financial institutions sought to resolve these problems by negotiating APAs with the IRS.

In 1994, the IRS published Notice 94-40, which provided a generic description of the IRS' experience with global dealing operations conducted in a functionally fully integrated manner. Notice 94-40 specified that it was not intended to prescribe rules for future APAs or for taxpayers that did not enter into APAs. Moreover, Notice 94-40 provided guidance only with respect to businesses conducted in a manner that financial institutions argue is fairly uncommon.

In 1998, the IRS issued proposed regulations providing guidance regarding the allocation of income from global dealing in financial products. The proposed regulations also included rules regarding the source of income from global dealing, to the extent that such income is not otherwise sourced under the Code, and rules for determining when such income will be treated as effectively connected with a U.S. trade or business.

Under the 1998 proposed regulations, taxpayers determine in three steps the amount of income from a global dealing operation over which the United States will claim taxing jurisdiction. In the first step, a global dealing operation allocates income to different legal entities. General principles of existing transfer pricing regulations would apply, with modifications necessary to reflect the different economic factors that affect pricing in a financial services business. Under the proposed regulations, marketing, pricing, and risk management are higher-value participant functions that must be compensated under the global dealing regulations. The determination of whether compensation for other functions is at arm's length is made under other applicable transfer pricing regulations. For example, the legal, accounting, and clerical functions performed by the back office of a financial institution are all functions for which an arm's length return may be determined under existing transfer pricing regulations. However, the proposed regulations were silent as to whether the provision of capital is a participant function and, thus, how it should be compensated, although examples demonstrated that acting as a counterparty to transactions constituted acting as a dealer in securities, which was identified as a participant function.

The second step is the determination of the source of income allocated to each legal entity. The 1998 proposed regulations provided under section 863 special source rules only for items of income for which a source rule is not specifically provided under the Code. Thus, the special source rules applied to notional-principal contracts, but not to dividends or substitute dividends.

For purposes of applying the source rules, each separate branch of a taxpayer is treated as a participant in the global dealing operation, with income being allocated to each participant under the transfer pricing rules described above. As a result, income from a single transaction may be sourced to more than one location, provided that the allocation methodology satisfies the arm's length standard.

In practice, the 1998 proposed regulations created uncertainty regarding the sourcing of global dealing income of U.S.-resident capital providers that did not maintain separate profit and loss accountings for each location where participant functions were performed. As a result, many U.S. taxpayers continued to treat their global dealing income entirely as U.S.-source income despite significant and sometimes exclusive participant contribution by foreign affiliates. Such treatment also resulted in interest expense allocations to domestic-source income under the asset method in Treas. Reg. § 1.861-9T(g). Further uncertainty resulted from dealing operations conducted in separate tax jurisdictions through agents who exercised contractual authority on behalf of U.S.-resident capital providers.

The final step, applicable only to foreign taxpayers engaged in a trade or business within the United States, is the determination of whether income is effectively connected to a U.S. trade or business ("ECI") and, therefore, subject to tax on a net basis in the United States. The 1998 proposed regulations provide that only income treated as derived from U.S. sources will be treated as ECI. Although statutory sourcing rules generally prohibit changing or splitting the source of FDAP income such as interest and dividends, the 1998 proposed regulations provide that such amounts may be split as to whether they are ECI or non-ECI. As with sourcing, the existence, or not, of a permanent establishment ("PE") is critical to the determination of whether, to what extent, and in what manner securities-dealer income (including certain foreign-source interest and dividends) of a foreign entity is subject to U.S. tax. Notably, ECI determinations under the Code are not contingent upon a finding of a PE. Accordingly, the activities of an agent could cause income to be effectively connected with a trade or business under the Code, but attribution for treaty purposes may depend upon the activities either of an office of the foreign person or a dependent agent. However, the ECI rules in the 1998 proposed regulations did not always result in symmetry of allocation and source treatment of global dealing income since the allocation of FDAP income does not change its source under the Code.

In addition to the rules regarding the allocation of income between taxing jurisdictions, the 1998 proposed regulations included rules under section 475 to deal with timing mismatches that can result if the separate existence of each desk is ignored. Under these rules, if certain threshold requirements are met, an interdesk agreement will be treated as if it were an agreement between separate taxable entities. Thus, each desk that is a party to the agreement will account for the agreement under the desk's own method of accounting. In most cases, the dealer desk will mark to market its position in the

agreement under section 475 while the sales or marketing desk will use hedge-accounting principles to match the recognition of income, expense, gain, or loss from its position in the interdesk agreement with the associated risk from its position with a customer.

These rules reflect a policy judgment that for purposes of determining the income of separately managed business units of a single taxpayer, intradesk symmetry is more important than interdesk symmetry. In other words, it is more important to have each desk's income determined consistently with its overall method of accounting applicable to all of its activities, than it is to ensure that the desks are accounting for interdesk transactions symmetrically. In addition, as a practical matter, it is virtually impossible to apply existing timing rules to global dealing operations without respecting interbranch transactions. For this reason, many global dealing operations have entered into APAs that allow them to account for interdesk and interbranch transactions in a manner consistent with the 1998 proposed regulations.

As discussed in Section F, the Treasury intends to issue reproposed global dealing regulations addressing these issues.

3. The Potential Scope for Income Shifting Under the Current Regulations

Based on the IRS' experience, and in light of the critical assessment of the current transfer pricing regulations discussed above, the Treasury Department believes that there is some potential for income shifting from non-arm's length transfer pricing under the current regulations. This potential is perhaps most acute with respect to CSAs, but is also possible with respect to the provision of intercompany services and other transactions.

The opportunity to manipulate intercompany prices is a function of both the relative value of the transferred property to the taxpayer's business, and the difficulty in reliably pricing the transaction (which tends to support a wider range of practically "acceptable" arm's length prices). At one end of the spectrum, there is little risk of income shifting with respect to the intercompany transfers of commodities that are a relatively minor input to the production process: the value of the transferred property is small relative to the operations of the business, and there are likely to be readily available reliable comparable transactions that define the arm's length price within a narrow, and not easily manipulable, range. On the other end of the spectrum, there is significant risk of income shifting from transfers of valuable intellectual property that are crucial to the core business of a taxpayer and that are difficult to value accurately. The risk of income shifting is further compounded by unclear transfer pricing valuation guidance and by the failure of some taxpayers to define the terms precisely under which intellectual property transfers take place.

The Treasury Department believes that CSAs under the current regulations pose significant risk of income shifting from non-arm's length transfer pricing. In addition to the valuation and definitional problems discussed above, CSAs often involve the key value-driving intangibles of a business. For example, it is not uncommon for CSAs to be for "future generations" of *all* products or licenses derived from the core technologies of a multinational group. Under the 1996 regulations, each participant "owns" the cost-shared intangibles that it exploits in its market. Thus, once a buy-in payment is undervalued, the IRS has little practical opportunity for redress. The IRS is effectively limited to making adjustments only to make each participant's share of the intangible

development costs incurred under the CSA equal to its share of the reasonable anticipated benefits from the CSA. In other words, only the relative shares of ongoing intangible development costs may be adjusted, and not the buy-in payments for contributed pre-existing intangibles that are contributed to the CSA. In this way, companies may effectively achieve the transfer of valuable intangibles to offshore locations for less than the full value required by section 367(d) and section 482 of the Code.

Compared to CSAs, intercompany-services transactions pose substantially less income-shifting risks. In practice, the vast majority of the services covered are low-margin "back-office" services that currently may be priced at cost under an administrative safe harbor intended to reduce compliance burdens for taxpayers and the IRS. Nevertheless, intercompany services may "embed" valuable intangibles. Therefore, to the extent that the current regulations might allow different outcomes for economically identical transactions depending on whether such transactions are characterized as "services" or as "intangible transfers," taxpayers could potentially exploit this asymmetry to shift income.

E. Income Shifting from Transfer Pricing: Evidence from Tax Return Data

1. Introduction

Transfer pricing analysis is intrinsically an analysis of specific facts and circumstances. Whether and the extent to which there may be income shifting from non-arm's length pricing of intercompany transactions can only be definitively determined at the very detailed level of the particular transactions under review, or perhaps at a level of aggregation seldom higher than a single company within a multinational group. It is difficult to draw conclusive inferences from aggregated data (that is, company-level data from hundreds or thousands of companies) for two reasons.

First, apparent income shifting in the aggregate data may in fact be fully supportable when specific transactions are analyzed. For example, it might be observed that the CFCs of U.S.-based multinational groups operating in low-tax jurisdictions have significantly higher profitability than the CFCs of these same U.S.-based multinational groups operating in high-tax jurisdictions. For a particular CFC, however, this result may not necessarily be indicative of non-arm's length pricing of intercompany transactions. For example, a CFC operating in a low-tax jurisdiction may have developed a particular technology itself (for example through the independent efforts of its research activities) from which it earns above-normal returns, while a CFC in a high-tax jurisdiction may undertake only low-value routine activities that warrant relatively low profitability at arm's length (e.g., a similar level of profitability as that of unrelated companies undertaking similar functions and risks). Or MNCs may simply invest more in low-tax jurisdictions. The differential in profitability may be related to such differences in investment levels, as profitability tends to be related to capital intensity, all else being equal.

Second, transfer pricing transactional detail may be "buried" within the broader financial data that are typically used for empirical analyses. There is significant non-transfer pricing "noise" that hinders the ability to isolate transfer pricing effects, or to compare reliably the effects over time. For example, the "check-the-box" regulations issued in 1997 resulted in greater use of hybrid entities. One type of hybrid entity is an

entity disregarded as separate from its owners according to U.S. tax rules, even though it may be a corporation under foreign law. Under U.S. rules, the hybrid "disappears" as its profit and loss results are rolled up into the return of its parent/affiliate. Importantly, what disappear are "zero sum" intercompany (which become interbranch) transactions. Thus, analysis of data that includes periods both before and after the issuance of the check-the-box rules would have to account for the fact that intercompany transactions of some companies may disappear from the data after an election is made to treat what had been a subsidiary corporation as a branch. This makes comparisons across such periods more difficult than they otherwise would be.

The years examined in this study are 1996 (prior to the 1997 check-the-box rules), 2000, and 2002.[69] Although the impact of the check-the-box rules bears most notably on intercompany interest payments (which this analysis explicitly eliminates from consideration in order to isolate, to the extent possible, other transfer pricing effects), the use of disregarded entities may itself further encourage non-arm's length pricing between foreign affiliates controlled by U.S. parents.[70] Therefore, some caution is required in comparing 1996 and earlier years to 1997 and subsequent years. One reason is that under the rules for filing Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, a CFC that checks the box to become a branch of another CFC disappears from the tax file.[71] The "remaining" CFC may be either in a low-tax or a high-tax jurisdiction. Another reason is that important transfer pricing regulatory developments also affected years subsequent to 1996, for example the 1996 cost sharing regulations. Attempting to disentangle the transfer pricing effects that may be due to the check-the-box regulations from those that may be due specifically to the cost sharing rules is difficult, although overall trends are still discernable.

2. CFCs of U.S.-Based Multinational Groups – Profitability in High-Tax Versus Low-Tax Jurisdictions

Notwithstanding the shortcomings discussed above, an examination of tax return data may be useful in detecting and understanding patterns or relationships in the data that may point toward income shifting from non-arm's length transfer pricing among related corporations. This section presents a preliminary empirical analysis of such potential income shifting.

There are two initial considerations in undertaking and evaluating an analysis of tax data. First, the analysis should control, to the extent possible, for factors *other* than transfer pricing manipulation that may cause observed differences in the data. Second, given the transactional focus of transfer pricing, any aggregated data analysis would not in itself be determinative, but would be used most appropriately in conjunction with a more targeted analysis of explicit areas of transfer pricing that may be susceptible to income shifting from non-arm's length transfer pricing, such as those areas discussed in Section D.

---

[69]The years 2002 and 2000 are the two most recent for which data are available (components of the database are only compiled every other year). In addition, 1996 is included in order to benchmark the updated data to the period examined in a prior analysis discussed below (Grubert (2003)).

[70] See Altshuler and Grubert (2006) and Mutti and Grubert (2006).

[71]This issue would be particularly troublesome if the empirical analysis employed a "panel" data analysis; that is, an analysis that tracked particular CFCs over time.

This transfer pricing analysis seeks to focus, to the extent possible, on related party transactions *other* than intercompany loans. A separate analysis of income stripping from the use of intercompany or interbranch debt is discussed in the study of earnings stripping in this report.

The incentives and mechanisms to shift income are available to domestic corporations and their foreign affiliates, regardless of whether the transactions are between U.S. parents and their CFCs, or between foreign parents and their domestic corporations. The tax data that best facilitated the analysis of income shifting in this section relate to domestic corporations and their CFCs, but the results could be interpreted more broadly.

A CFC is defined in the Code as a foreign company, more than 50 percent of which is owned by "U.S. shareholders" (defined as U.S. persons, including entities, that own at least 10 percent of the voting power of the company). If a multinational group is systematically engaging in non-arm's length pricing of intercompany transactions in order to facilitate purely tax-advantaged outcomes, one would expect to observe higher CFC profitability in low-tax jurisdictions and lower CFC profitability in high-tax jurisdictions, assuming other factors that affect profitability are equal. This section undertakes an investigation of CFC profitability based on tax return data for the years 1996, 2000, and 2002.[72]

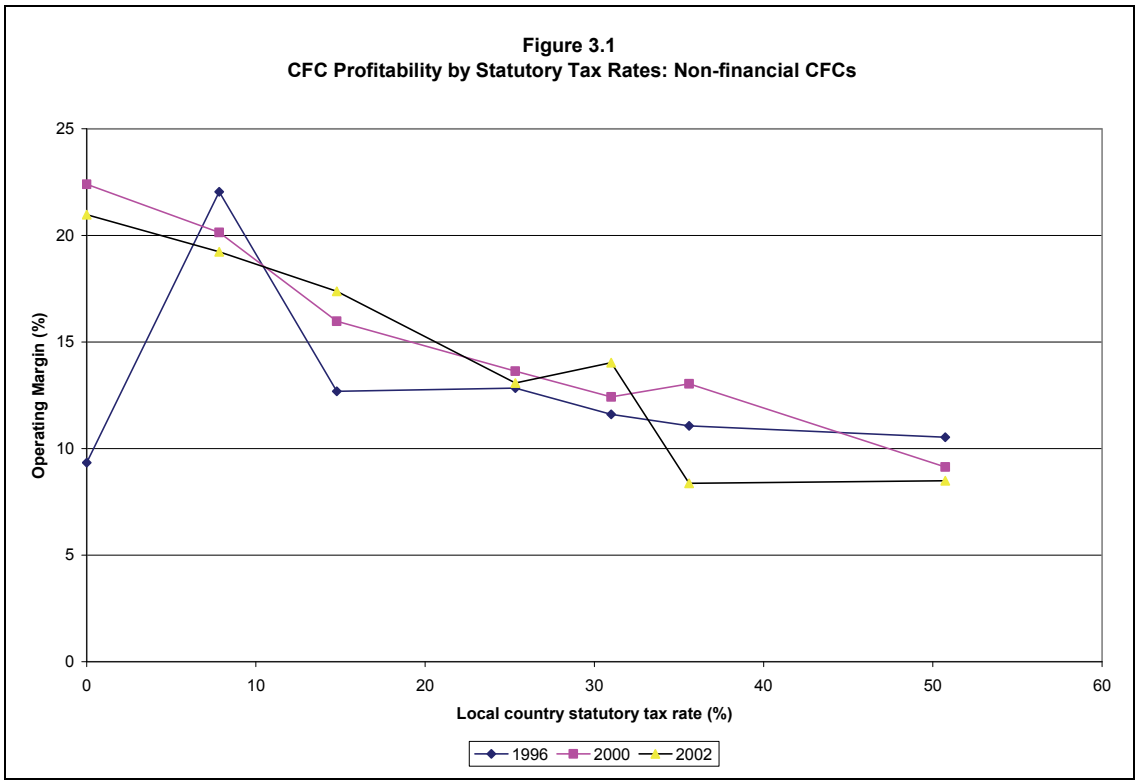
Figure 3.1 depicts the relationship between CFC profitability, measured by the ratio of operating profits to sales (or operating margin), and the statutory tax rate of the CFC jurisdiction.[73] Operating profits are defined as pre-tax earnings excluding interest income and interest expense, but including 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 and intangible assets, 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 Treas. Reg. § 1.482-5. Statutory tax rates are used

[72]Specifically, the data used in this analysis are derived from the corporate income tax return (Form 1120) for each of the years, merged with information from Form 5471 (an information return filed for each of the domestic parent's CFCs), and Form 1118 (by which a parent calculates the 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 (e.g., SEC filings) of the parent. The sample is derived from the data for the largest CFCs where detailed information was available. The sample is further restricted by excluding financial CFCs and CFCs with losses. This latter restriction was imposed because firms with losses may face different income-shifting incentives than CFCs with net income.

[73]The term "operating profits" (and the associated term "operating margin") has a particular meaning to transfer pricing practitioners, and so is used here. However, the term differs slightly from "operating income" as used in the earning-stripping literature (for example in Grubert (1997)) and discussed in the Earnings Stripping Study in this report. Compared to definition of operating income in the study of earnings stripping, operating profits discussed in this section include depreciation deductions and royalties paid and received.

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.

Figure 3.1 depicts the relationship between operating margin and tax rates for all non-financial CFCs for each of the tax years analyzed. In general, the curves slope downward (although certainly not monotonically, notably in 1996), indicating an inverse relationship between pre-tax profitability and tax rates. 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.



Although the data depicted in Figure 3.1 generally show that pre-tax operating margins are higher in low-tax countries and lower in high-tax countries, they do not provide information on the factors that might be contributing to those differences. In particular, many factors that affect profitability are not necessarily related to inappropriate income shifting (whether achieved through transfer pricing or through other means). For example, CFCs in low-tax jurisdictions may have more asset-intensive operations, which tend to be associated with higher profit margins. CFC start-ups in a given year may happen to be more prevalent in high-tax jurisdictions. CFCs in more research-intensive industries may operate in lower tax jurisdictions, and in fact may develop their own intangibles to exploit. These non-transfer pricing factors could also be consistent with the observed inverse relationship between CFC profitability and statutory

tax rates. Finally, the data depict single year snap-shots of CFC activities. Cyclical effects or other non-transfer pricing aberrations could also affect profit differences.

In order to examine more carefully the relationship between CFC profitability and local country tax rates – in particular to capture as many of the non-transfer pricing factors as possible – a more refined empirical analysis is required.

A number of studies have undertaken empirical investigations of income shifting.[74] These can be categorized based on the data sources used: (1) aggregated, country-specific data; (2) firm-level data based on public (non-tax) filings of publicly traded companies; and (3) firm-level data based on tax and non-tax filings of U.S.-based MNCs and their CFCs.

In the first category, Grubert and Mutti (1991) use aggregated country-level National Income and Products Account (NIPA) data on U.S-based MNCs' affiliates to examine the relationship between profit rates and local country statutory tax rates, while controlling for GDP growth, and conclude that the pattern of profitability in high-tax and low-tax jurisdictions is consistent with income-shifting behavior. Hines and Rice (1994) use country-level aggregated data of non-bank CFCs (i.e., treating all foreign affiliates in a country as if owned by representative domestic parent firms), and find evidence of sensitivity of profitability to local country effective tax rates, adjusting for financial structure and capital employed. Clausing (2001) uses aggregated country-level data on intra-firm trade flows from the Bureau of Economic Analysis and shows that the intra-firm trade balance between the U.S.-based MNC and its foreign affiliates, as well as intra-firm sales between foreign affiliates of U.S.-based MNCs, are related to effective tax rates in a manner consistent with, although not necessarily entirely explained by, income shifting.

In the second category, Harris et al. (1993) use cross-sectional firm-level panel data from the public filings of 200 domestic manufacturing corporations to investigate how differences in U.S. taxes as a percentage of U.S. sales or assets relates to subsidiary operations in foreign tax jurisdictions. Taking into account company characteristics (e.g., research and development and advertising as proxies for intangible assets, interest expense, and number of employees), and using indicators on the presence of an affiliate in a particular low-tax or high-tax jurisdiction, they show evidence of income shifting out of or into the United States consistent with (that is, negatively correlated with) tax-rate differentials between the United States and foreign jurisdictions. Harris (1993) uses firm-level data from public filings of domestic and foreign corporations to investigate the effects from major capital cost provisions in the Tax Reform Act of 1986 whose theoretical effect would unambiguously increase the incentive to shift income and/or capital to the United States from foreign affiliates independent of relative tax rates. Taking into account company characteristics pertaining to the level of "flexible" expenses (e.g., research and development, advertising, and interest expense), and investigating separately from the U.S. and foreign perspective, he shows evidence that

[74]These studies refer to "income shifting" rather than the narrower concept of "income shifting from non-arm's length transfer pricing." "Income shifting" in these studies might more appropriately be termed "potential income shifting," and often refers to an inverse relationship between profitability and tax rates after accounting for non-tax economic factors. This could incorporate, for example, not only non-arm's length transfer pricing but also the aggressive use of inter-corporate debt.

multinational groups shifted more income into the United States after the Tax Reform Act of 1986, and that they did so quickly. Jacob (1996) uses similar data to extend Harris (1993) by accounting for the volume of intercompany transactions between firms. His analysis provides evidence that transfer pricing, rather than other factors, may explain the income shifting.

In the third category, Grubert and Slemrod (1998) use firm-level tax panel data of U.S.-based MNCs with subsidiaries in a particular low-tax jurisdiction (Puerto Rico), supplemented by data from public filings of the U.S.-based MNCs. They investigate the joint-investment and income-shifting choices available to multinational firms, and find evidence that a large proportion of U.S. investment in Puerto Rico is due to the income-shifting opportunities (uniquely) available there. Grubert (2003) seeks, in part, to address the somewhat limited applicability of Grubert and Slemrod (1998) by extending the analysis across a more comprehensive spectrum of low-tax and high-tax foreign jurisdictions. He uses firm-level tax data of CFCs, each matched to domestic parent-level tax return data, and further supplemented with data from public filings of the domestic parent. The paper evaluates the correlation between pre-tax profitability and local country statutory tax rates, controlling for parent and CFC characteristics unrelated to tax (e.g., CFC asset intensity, parent size, start-ups, and in particular the presence of intangible assets), and finds evidence of income shifting, primarily associated with industrial (rather than marketing) intangibles. The analysis is further extended to investigate and quantify the extent to which tax incentives to shift income increase the volume of related-party transactions.

A recent analysis (McDonald, 2007) examines potential income shifting from non-arm's length transfer pricing by updating the analysis in Grubert (2003). The analysis was undertaken in two sections. In the first part, the analysis modifies the model in Grubert (2003) by excluding effects from intercompany debt, and extends the analysis through 2002. The second part further extends Grubert (2003) by incorporating proprietary transfer pricing-specific data.

The first section of the analysis examines the relationship between a CFC's pre-tax profitability (measured as the ratio of CFC operating profits to CFC sales (i.e., the operating margin depicted in Figure 3.1) and the local country's statutory tax rate. As in Grubert (2003), the analysis shows that, even when important non-tax (and statistically significant) factors are taken into account, higher local country statutory tax rates had a negative and statistically significant correlation with the operating margin of CFCs. The correlation increases significantly between 1996 and 2002, indicating a widening of the profitability disparities between high-tax and low-tax jurisdictions over that time (although these results should be interpreted with some caution in light of the post-1996 check-the-box regime). As in Grubert (2003), the results of the analysis do not in themselves *necessarily* point to specific inappropriately priced intercompany transactions as the underlying cause of the inverse relationship between tax rates and profitability. The data are aggregated beyond the transactional level necessary for such a determination and, in addition, the data used in this section did not allow for accounting for transfer pricing-specific factors, such as participation in CSAs. Nevertheless, because the analysis takes into account many non-transfer pricing economic factors that could affect profitability, the hypothesis that multinational groups engage in non-arm's length pricing

of intercompany transactions in order to facilitate purely tax-advantaged outcomes cannot be rejected by the available data, in both the pre-check-the-box and post-check-the-box years. These results are consistent with the existing economics literature.

The second section of the analysis supplements the tax return data with survey data on CSAs to determine whether CSA status influenced the results. The data are derived from a survey undertaken by the IRS of its international examiners and economists in order to identify those MNCs that have in the past engaged in CSAs or are currently engaged in CSAs with any of their CFCs. The survey information includes the names of domestic parent companies that have at least one CSA, the starting year of the CSAs identified, the names of the CFCs participating in the CSAs, and some information on audit activity of the CSAs. This survey information was appended to the data used in the first section of the paper. While the survey data cannot be considered comprehensive, the information was used to assess the distribution of profitability across taxing jurisdictions for CFCs of this particular group of MNCs, and to compare these CFCs with CFCs of MNCs not engaging in CSAs. The analyses provide two notable results. First, CFCs whose parents engage in CSAs tend to be more profitable overall than other CFCs. Second, CFCs whose parents engage in CSAs do tend to have higher profitability in low-tax jurisdictions and lower profitability in high-tax jurisdictions than their non-CSA cohorts, generally at statistically significant levels, when controlling for the other non-tax factors and the age of the CSA. The results suggest that CFCs whose parents engage in CSAs tend to show more evidence of potential income shifting, but again it is unclear the extent to which this may be due to CSAs themselves or to other factors.

3. Conclusion

As discussed above, while the ability to draw transfer pricing-specific inferences from tax return and CSA data is limited to some extent, the analysis of the data does not allay the concerns about potential income shifting from non-arm's length transfer pricing derived from the more detailed analysis of the administration of the existing transfer pricing regulations, especially CSAs, as discussed in Section D.

F. Improving Transfer Pricing: Recent Regulatory Efforts

Sections C and D discussed the progress made in developing and administering transfer pricing rules since 1986. Sections D and E discussed potential shortcomings of the current transfer pricing regulatory regime from a legal/administrative and empirical basis, respectively. This Section F discusses three projects undertaken to address these concerns: (1) the proposed cost sharing regulations (2005), (2) the temporary and proposed services regulations (2006) (preceded by proposed services regulations in 2003); and (3) reproposed global dealing regulations (anticipated shortly).

1. Proposed Cost Sharing Regulations (2005)

Proposed cost sharing regulations issued in 2005 adopt as a fundamental principle an "investor model" for addressing the relationships and contributions of controlled participants in a CSA. Under this model, each controlled participant may be viewed, at the outset of the CSA, as making an aggregate investment, attributable to both future cost contributions (ongoing share of intangible development costs) and current "external contributions" (the preexisting advantages that the parties bring into the arrangement), for

purposes of achieving an anticipated return appropriate to the risks of the CSA over the term of the development and exploitation of the intangibles resulting from the arrangement.

In evaluating the appropriate compensation for external contributions, it is necessary, under the investor model, to determine (1) what an investor would pay at the outset of a CSA for an opportunity to invest in that arrangement, and (2) what a participant with external contributions would require as compensation at the outset of a CSA to allow an investor to join in the investment. This is nothing more than a restatement of the familiar "willing buyer/willing seller" standard for determining fair market value generally.

The appropriate "price" of undertaking a risky investment is typically determined at the time the investment is undertaken, based on the *ex ante* expectations of the investors. Given the uncertainty about whether and to what extent intangibles will be successfully developed under a CSA, *ex post* interpretations of *ex ante* expectations are inherently unreliable and susceptible to abuse. Accordingly, an important implication of determining the arm's length result under the investor model, reflected in the methods set forth in the proposed regulations, is that compensation for external contributions is analyzed and valued *ex ante*. The *ex ante* perspective is fundamental to achieving arm's length results.

The proposed regulations provide supplemental guidance for determining the appropriate compensation for external contributions. The proposed regulations clarify the contractual terms under which external contributions are made. Specifically, the valuation of the rights associated with external contributions cannot be artificially limited by purported conditions or restrictions, as could arguably occur under the current regulations. Rather, the arm's length compensation for external contributions must reflect the type of transaction and contractual terms of a "reference transaction" by which the benefit of exclusive and perpetual rights in the relevant resources or capabilities are provided. This compensation will be determined by a method that will yield a value for the obligation of any given controlled participant that is consistent with that participant's share of the combined value of the external contribution to all controlled participants. The definition of external contribution does not require actual *ex post* use, but merely that the resource or capability is reasonably anticipated to contribute to developing cost-shared intangibles. In addition, external contributions are not limited to intangibles, but also include other resources or capabilities.

The proposed regulations set forth new specified methods and provide rules for application of existing specified methods, for purposes of determining the arm's length compensation due with respect to external contributions. The proposed regulations also enunciate general principles governing all methods, specified and unspecified, for these purposes. Taken together, the guidance provided by the proposed regulations helps to address the serious buy-in valuation problems identified in Section D.

The proposed regulations require that compensation for external contributions be consistent with an investor model for cost sharing. Two key principles follow from the investor model regarding such compensation. The first is that, *ex ante*, the aggregate investment (external contributions plus subsequent cost sharing payments) would be

expected to yield an anticipated rate of return (above and beyond the return relating to routine functions undertaken in exploiting the intangible) commensurate with the riskiness of the CSA (reflected in the appropriate discount rate). It should be noted, however, that the actual (or *ex post*) return to the cost sharing participants may be higher or lower than the anticipated return determined at the outset of the CSA, reflecting the legitimate return to risk-taking by the participants. Once cost sharing parameters (e.g., the buy-in contingent payment rate) are determined on an *ex-ante* basis, the cost sharing arrangement is allowed to play itself out.

The second principle is that, *ex ante*, the appropriate return to the aggregate investment is measured over the entire period of development and exploitation of cost-shared intangibles. Included in this principle is the concept that no part of the investment should be viewed as separately earning a return over a more limited period. As a general matter, successful completion of each step in a research program is a necessary condition for the completion of the program as a whole and its contribution continues over the entire life of the project. For this reason, each aspect of the research program must be viewed as contributing to the success of the program as a whole (and not just its success for some limited period of time).

The regulations specify methods for properly valuing external contributions (including the "comparable uncontrolled transactions" (CUT) method, the "acquisition price" method, the "market capitalization" method, the "income" method, and the "residual profit split" method) and also provide guidance on using unspecified methods. This guidance provides much needed clarification on applying the arm's length standard under section 482 to the particularly complex valuation issues that arise under CSAs, and also more clearly addresses particular fact patterns that are commonly encountered by the IRS. In particular, the income method specifically addresses the situation where only one controlled participant brings non-routine external contributions into the CSA. In such circumstances, the other controlled participant or participants essentially only commit to bearing their respective share of ongoing costs and bring only routine contributions for purposes of exploiting cost-shared intangibles. As discussed in Section D, it is this situation that the Treasury Department believes is most susceptible to income shifting from non-arm's length transfer pricing.

The proposed regulations provide greater clarity on how the "commensurate with income" standard is to be applied to CSAs. Building on the investor model, the proposed regulations provide guidance on the periodic adjustments that the IRS Commissioner may make in situations where the actual results of a controlled participant's investment attributable to cost contributions and external contributions are widely divergent from reasonable expectations at the time of the investment (typically the outset of the CSA). Exceptions are provided, including one under which the taxpayer may establish that the differential is due to events beyond its control that are extraordinary and not reasonably anticipated at the outset of the CSA.

The disadvantages the IRS faces in examining, necessarily after-the-fact, the profit potential reasonably expected by taxpayers at the time of a transfer of intangible property between related parties justifies the *ex post* perspective necessarily inherent in

the commensurate with income standard.[75] This "information asymmetry" between the taxpayer and the IRS is, thus, the rationale for, and foundation of, the periodic-adjustment rules. The IRS Commissioner's ability to evaluate controlled participants' deals with regard to high-profit potential intangibles is hampered, not only by the absence of comparables, but by an asymmetry of information vis-à-vis the taxpayer. The taxpayer is in the best position to know its business and prospects. The IRS Commissioner faces real challenges in ascertaining the reliability of the *ex ante* expectations of the taxpayer's arrangements in light of significantly different ex post outcomes. While risk and uncertain outcomes are typically the hallmarks of high-profit potential intangibles, results that are significantly more favorable to the taxpayer than the purported *ex ante* expectations raise concerns whether the terms of the initial arrangement reflect a conscientious upfront valuation. These concerns are particularly problematic given the information asymmetry between taxpayers and the IRS. Periodic adjustments effectively permit the IRS to impute an arm's length arrangement that appropriately reflects the profit potential of transferred intangibles where the taxpayer's pricing fails to reflect a conscientious upfront valuation effort. Because the guidance on periodic adjustments is intended to address the problem of information asymmetry, and because it is extremely unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result, periodic adjustments of this type may only be exercised by the Commissioner. However, the periodic-adjustment rules are not intended to provide a basis for the IRS to make adjustments to buy-in payments simply because the actual return to the buy-in payor may have exceeded the anticipated return.

Finally, the proposed regulations provide stronger documentation requirements than those under the existing final regulations. Taxpayers must comply with up-front contractual requirements, accounting requirements, reporting requirements, and other documentation requirements that ensure fair and timely assessment of the CSA by the IRS. The Treasury Department believes that the proposed cost sharing regulations provide a marked improvement over the current regulations (Treas. Reg. § 1.482-7), and will help ensure that key cost sharing financial parameters, most notably compensation for external contributions, are determined in accordance with the arm's length standard. To the extent that income shifting from non-arm's length transfer pricing has resulted from the misapplication of the current cost sharing regulations, expeditious finalization of the proposed regulations should be a high priority. The Treasury Department is currently reviewing taxpayer comments on the proposed regulations.

---

[75] The legislative history to the 1986 addition of the commensurate with income standard to section 482 indicates that this *ex post* evaluation of *ex ante* taxpayer expectations was clearly intentional:

> The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer.

H.R. Rep. No. 99-426, 99th Cong., 1st Sess., 1986-3 C.B. Vol. 2 420,425.

2. Temporary and Proposed Services Regulations (2006)

Background: Proposed Services Regulations (2003)

The predecessor to, and intellectual foundation of, the 2006 temporary and proposed services regulations was the proposed services regulations published in 2003. The 2003 proposed regulations provided generally that the arm's length charge in a services transaction must be determined by using one of the transfer pricing methods provided or referenced in the regulations. The guidance on methods was generally consistent with the 1994 regulations applicable to transfers of tangible and intangible property, and was consistent with international standards with respect to services transactions. The methods provided or referenced include the "comparable uncontrolled services price" method, the "gross services margin" method, the "cost of services plus" method, the existing comparable-profits method, as adapted to services, the existing residual profit split method, and unspecified methods, to the extent such methods provide the most reliable measure of an arm's length result under the best method rule. The provisions in the subsequent 2006 temporary and proposed regulations, described below, are substantially similar to the corresponding provisions in the 2003 proposed regulations.

The proposed regulations provided a new transfer pricing method for low-value services such as routine back-office services. This "simplified cost based method" (SCBM) was intended to replace the current cost safe harbor with a simplified method based on comparability principles that would be more consistent with the arm's length standard and yet require a less robust analysis than under the general transfer pricing rules.

The SCBM would have limited the ability of the IRS to make allocations it could otherwise make under the general rules. Generally, the IRS would have been able to make an allocation under the SCBM only if it determined that the arm's length markup on "total services costs" exceeded the markup charged by the taxpayer by at least the "applicable number of percentage points."

The applicable number of percentage points would be six if the amount charged by the taxpayer is equal to total services costs, and declines ratably to zero by one percentage point for every increase of two percentage points in the markup on total services costs charged by the taxpayer. For example, if the amount charged by the taxpayer is equal to total services costs (that is, if the taxpayer charges no markup), then the IRS could only make an allocation if it determined that the "true" arm's length markup on total services costs exceeds 6 percent. If the amount charged by the taxpayer is 4 percent above total services costs, the arm's length markup necessary before the IRS can make an adjustment is 8 percent. Consequently, as the taxpayer's transfer price increases, the safe harbor "ceiling" over the taxpayer's transfer price declines. The safe harbor is eliminated when the arm's length markup exceeds 10 percent.

In addition to the 10-percent upper bound, several quantitative and qualitative tests would have applied to filter out services that should be subject to a more robust arm's length analysis, including a list of categories of transactions such as manufacturing, production, extraction, construction, distribution, research, and financial transactions. No inference was intended regarding either the arm's length markup on total services costs

with respect to any of the excluded categories or types of transactions or the appropriate transfer pricing method for analyzing any particular transaction. In particular, no inference was intended that the arm's length markup for such transactions in a particular case would exceed 10 percent of total costs. Rather, these transactions are ineligible for the SCBM because the Treasury Department concluded that a full transfer pricing analysis is appropriate.

The 2003 proposed regulations also provided guidance intended to coordinate and harmonize the rules applicable to services related to intangibles with the rules applicable to transfers of intangible property. The purpose of this guidance was to ensure that transfer pricing rules, when applied to economically similar transactions, reach substantially similar results. For example, the proposed regulations provided that the arm's length result for a services transaction that results in, or has an effect similar to, the transfer of intangible property must be determined or corroborated by an analysis under the transfer pricing rules for transfers of intangible property. The proposed regulations also included provisions regarding the use or imputation of contingent-payment arrangements in services transactions and amendments to make the residual profit split method more suitable to services transactions, each of which was intended to contribute to better coordination and harmonization of the rules applicable to services with those applicable to transfers of intangible property.

The 2003 proposed regulations also provided rules and examples regarding the treatment of services performed in connection with the development or enhancement of an affiliate's intangible property, particularly in the context of the development of marketing intangibles. In general, these rules provided that such services must be compensated either through a separate charge or by being taken into account as a comparability factor in a larger integrated transaction, such as a license. Because of safeguards in the SCBM and the rules coordinating the pricing of services and transfers of intangibles, it would no longer be necessary to allocate income by imputing shifts of ownership of intangible property to service providers, as under the current regulations. Additionally, rather than allowing for the possibility of multiple owners of intangible property, the proposed regulations recognized that, based on intellectual-property law or contractual or other legal provisions, there are distinct owners of distinct intangibles. For example, the licensor of a trademark may be the owner of the trademark under intellectual-property law, while the licensee is the owner of the license pursuant to its contractual terms. The trademark and the license are distinct intangibles with distinct owners, rather than a single intangible with multiple owners.

Temporary and Proposed Services Regulations (2006)

The Treasury Department received a substantial volume of comments on a wide range of issues addressed in the 2003 proposed regulations. Substantial changes were made in response to those comments. In order to achieve the goal of updating the 1968 regulations, while facilitating consideration of further public input in refining final rules,

regulations were issued in temporary and proposed form with a delayed effective date for taxable years beginning after December 31, 2006.[76]

As described in the 2003 proposed services regulations, the SCBM was intended to preserve aspects of the cost safe harbor (under Treas. Reg. § 1.482-2(b)) that provide appropriately reduced administrative and compliance burdens for low-margin services. At the same time, the existing rules would be brought more in line with the arm's length standard, and various problematic features of those rules would be eliminated. However, a number of commentators argued that the SCBM was actually counterproductive to its stated goals. These commentators contended that to apply the SCBM, taxpayers would potentially need to expend substantial sums to prepare comparability studies, perhaps separately for each of the numerous categories of back-office services. They contended that, although taxpayers have in-depth knowledge concerning their businesses and the relative value added by their back offices, the SCBM called for quantitative judgments that business people are not qualified to make by themselves, especially in the prevailing compliance environment. As a matter of proper accountability, taxpayers would be effectively required to devote significant compliance resources to enlist outside consultants or otherwise to develop support for those judgments.

Based on these comments, the 2006 temporary and proposed regulations eliminated the SCBM and replaced it with the "services cost method" (SCM). Specifically, the SCM provides for two categories of covered services that are eligible to be priced at cost (at the taxpayer's election) if certain conditions are met. The first category consists of specified covered services identified in a revenue procedure published by the IRS. Such services are identified in a revenue procedure based upon the determination of the Treasury Department that they constitute support services of a type common across industry sectors and generally do not involve a significant arm's length markup on total services costs. Because the government performs the analysis necessary to determine the eligibility of specified covered services, the compliance burden that might have been imposed by the SCBM is eliminated for a broad class of commonly provided services. The second category of covered services is certain low-margin covered services. Low-margin covered services consist of services for which the median comparable arm's length markup on total services costs, as determined under the general rules of Treas. Reg. § 1.482, is less than or equal to 7 percent.

Under the SCM, specified covered services or low-margin covered services otherwise eligible for the SCM will qualify for the method if the taxpayer reasonably concludes in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both. Unlike the quantitative judgment called for under the SCBM, this is a business judgment preeminently within the businessperson's own expertise. This test is intended to focus transfer pricing compliance resources of both taxpayers and the IRS principally on significant valuation issues. The test allows the IRS to reject any attempt to claim that a core competency of the taxpayer's business qualifies as a mere back-office service. This

[76]A subsequent Notice and Revenue Procedure further delayed the effective date, so that the temporary regulations will apply for taxable years after December 31, 2007, for provisions relating to the cost method provided in the regulations.

provision avoids the need to exclude from the categories of covered services certain back-office services that as a general matter and across a range of industry sectors are low-margin, but that in the context of a particular business, nonetheless, constitute high-margin services. That is, it permits the Treasury Department to include a greater range of service categories under the SCM, even though in specific circumstances an otherwise covered service of a particular taxpayer will be ineligible.

Finally, the SCM preserves the same list of categories of controlled services as the SCBM did that are not eligible to be priced under this method. The Treasury Department continues to believe that these are high-margin services for which total services costs constitute an inappropriate reference point, or other types of services that should be subject to a more robust arm's length analysis under the general section 482 rules.

The preamble to the 2003 proposed regulations indicated that in certain cases, the allocation or sharing among group members of expenses or charges relating to corporate headquarters or other centralized service activities may be consistent with the proposed regulations, but no further guidance was provided on such service-sharing arrangements. The 2006 temporary regulations explicitly provide this guidance through "shared services arrangements" (SSAs). SSAs provide a means for aggregating services and for allocating the total charge for services among more than one beneficiary.

Commentators observed that the definition of "total services costs" in the 2003 proposed regulations did not address situations in which the costs of a controlled service provider included significant charges from uncontrolled parties. Commentators claimed that such third-party costs should be treated as "pass through" items that, in most cases, should not be subject to the markup (if any) applicable to costs incurred by the renderer in its capacity as service provider. This comment was potentially relevant to all cost-based methods in the 2003 proposed regulations (i.e., Treas. Reg. § 1.482-9). The 2006 temporary regulations provide specific guidance to deal with this situation by allowing taxpayers, in certain circumstances, to evaluate controlled services transactions that involve third-party costs on a disaggregated basis. That is, where the costs of a controlled service provider included significant charges from uncontrolled parties, the controlled-services transaction may be analyzed either as a single transaction or as two separate transactions (i.e., the third-party costs are broken out separately), depending on which approach provides the most reliable measure of the arm's length result.

The provisions in the 2006 temporary and proposed regulations with respect to the coordination and harmonization of the rules applicable to services related to intangibles are substantially similar to the corresponding provisions in the 2003 proposed regulations, although a substantial number of clarifications and other modifications were made in response to taxpayer comments.

Notice and Revenue Procedure (2006)

In December 2006, the Treasury Department issued a Notice and Revenue Procedure relating to the temporary and proposed services regulations.[77]

[77]Notice 2007-5, 2007-3 I.R.B. 269 (Jan. 16, 2007) and Revenue Procedure 2007-13, 2007-3 I.R.B. 295 (Jan. 16, 2007).

The Notice provided a partial modification to the effective date, so that the temporary regulations will apply to taxable years after December 31, 2007, for all provisions relating to the SCM except the business-judgment rule. The modification was made in response to numerous taxpayer requests to allow sufficient time to modify accounting systems and to take other steps in order to comply fully with the temporary regulations. The Notice also clarified that that the application of the SCM is elective by taxpayers, and that taxpayers may use SSAs to make allocations of arm's length charges for services ineligible for the SCM that yield a benefit to multiple members of a controlled group.

Finally, in response to taxpayer requests, the list of specified covered services under the SCM was significantly broadened. The Revenue Procedure provides the updated list of specified covered services reflecting the modifications.

3. Reproposed Global Dealing Regulations

It has been almost 10 years since the global dealing regulations were proposed, and those regulations have not been finalized. During this time, global dealing in financial products has changed significantly, as a result of technological advances, globalization and interconnection of economic activity, and other factors. Accordingly, the Treasury Department has placed a high priority on reproposing global dealing regulations to reflect these changes.

The vast majority of dealing activity takes place within a handful of countries. As a result, treaties apply to most, but not all locations where global dealing operations are conducted. In order to avoid double taxation and to minimize disputes that may result among Competent Authorities, the reproposed global dealing regulations will comport with emerging income tax treaty principles as much as possible.

Older U.S. tax treaties generally do not adopt the arm's length standard provided for in Article 7 of the OECD Model Income Tax Treaty. However, several recent U.S. income tax treaties provide that the arm's length standard will be used to allocate profits within a single enterprise based on a functional analysis of assets used, risks assumed, and functions performed. These recent treaties cover the main financial centers in the world and represent the most common jurisdictions where the majority of global securities dealing operation are conducted. These agreements follow the work of the OECD project on attribution of profits to PEs and apply the OECD Transfer Pricing Guidelines to PEs by analogy. The OECD project represents the principal effort by member countries to reach agreement on the common principles to apply in determining business-profit attribution to a PE for business in general and for global dealing operations in particular. Importantly, the OECD attribution project vastly narrows the differences between its member countries on the attribution of financial income and the allocation of debt financing and equity capital. Resolution of these issues significantly eliminates double taxation in many cases or reduces the differences to levels where the competent authorities should often be able to reach agreements. The Treasury Department intends to issue reproposed global dealing regulations, consistent with this emerging agreement, which provide guidance to allow taxpayers to determine the amount of income from a global dealing operation that will be subject to tax in the United States. These regulations will also provide rules for determining the allocation and source of

income earned in a global dealing operation and the circumstances under which such income is effectively connected to a foreign corporation's U.S. trade or business.

G. Conclusions

The Treasury Department believes that the existing transfer pricing rules and compliance efforts must be continually monitored in order to ensure their effectiveness. There are certain aspects of the final regulations that may not be sufficiently complete and that may not function as intended. These include the rules for cost sharing arrangements, intercompany services, certain rules pertaining to marketing intangibles, and global financial dealings.

The cost sharing regulations must be revised to provide additional guidance to ensure arm's length compensation is paid for the external contributions each party may bring to a cost sharing arrangement. Many taxpayers have misinterpreted the current regulations, resulting in systematic undervaluation of buy-in payments. Additional guidance is necessary to value buy-in payments appropriately, to define more clearly what constitutes a cost sharing arrangement, and to specify more clearly how the commensurate with income standard applies to such arrangements.

The existing final services regulations have become outdated by the passage of time and are inadequate in handling the complexities of current multinational operations and transactions. The absence of updated services regulations has led to discontinuities between transfer pricing for services and transfer pricing for tangible and intangible property. The rules applicable to the development of intangible property, such as marketing intangibles, have been misapplied in practice and need to be revised. Similarly, the current regulations provide insufficient guidance for the highly complex intercompany transactions of financial-services companies undertaking global dealing operations, as well as for other financial transactions, such as the provision of financial guarantees.

Experience in administering the current transfer pricing regulations reveals that there is some potential for income shifting by taxpayers. This potential is perhaps most acute with respect to cost sharing arrangements, but is also possible with respect to the provision of intercompany services and financial transactions.

The economics literature has historically found empirical evidence that is consistent with income shifting from non-arm's length transfer pricing by multinational groups. The literature shows, for example, that pre-tax profitability of CFCs has been negatively correlated with local country statutory tax rates, taking into account real economic factors such as financial structure, capital employed, and other non-transfer pricing operational aspects of multinational groups. While the data and analyses do not provide direct evidence of specific transfer pricing manipulation, they do not allay the concerns about potential income shifting from non-arm's length transfer pricing derived from a critical assessment of the current transfer pricing regulations.

H. Recommendations

Based on this assessment of the effectiveness of current transfer pricing rules and compliance efforts, the Treasury Department believes, as reflected in the 2007-2008 Priority Guidance Plan, that the highest priority should be given to the prompt

finalization and implementation of the three transfer pricing regulation projects discussed in this study. These regulations will address known gaps in transfer pricing administration, and will eliminate common avenues for income shifting from non-arm's length transfer pricing available to multinational groups. While enhanced disclosure is generally helpful, it is not always cost effective and the Treasury Department is cognizant of the administrative burden already faced by companies in complying with admittedly complex transfer pricing rules. In fact, an important part of each of the regulatory projects has been specifying documentation and information requirements that allow for proper administration of the regulations at the lowest possible burden to taxpayers. Given the current disclosure requirements already in place (as well as the additional disclosure requirements that are part of the proposed regulations), the generally high audit rates of affected taxpayers, and the enhanced ability of the Competent Authority to exchange information with other tax jurisdictions, additional disclosure requirements are not recommended at this time.

IV. STUDY OF INCOME TAX TREATIES

A. Introduction

Section 806 of AJCA included the following mandate for a study of income tax treaties:

> The Secretary of the Treasury or the Secretary's delegate shall conduct a study of United States income tax treaties to identify any inappropriate reductions in United States withholding tax that provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly. The study shall include specific recommendations to address all inappropriate uses of tax treaties.

B. Executive Summary

The United States has a network of 58 income tax treaties that encompasses 66 countries. Through this network the United States seeks to minimize tax-related impediments to inbound foreign investment by reducing, and in many cases waiving, its statutory taxing rights on U.S.-source income earned by residents of its treaty partners. An underlying principle of U.S. tax-treaty policy is that the benefits accorded in these bilateral agreements must be safeguarded from abuse. In particular, adequate rules must protect against unintended and inappropriate application of the benefits provided in tax treaties.

The United States generally imposes a 30-percent gross-basis withholding tax on payments of dividends, royalties, and many types of interest earned by nonresidents who do not have a U.S. trade or business. U.S. tax treaties usually significantly reduce withholding taxes imposed by each treaty partner. Over the past several years the Treasury Department has developed, in consultation with the Congress, special rules for payments by U.S. Regulated Investment Companies (RICs), U.S. Real Estate Investment Trusts (REITs) and through other financial instruments, to combat abuse of treaty-based withholding rate reductions, particularly with respect to payments of dividends, interest, and insurance premiums. The Treasury Department is satisfied that these anti-abuse rules achieve the proper balance of preventing inappropriate reductions of withholding taxes while at the same time allowing cross-border economic activity to reach its full potential.

In addition, the United States has been a longstanding world leader in the development of limitation on benefits rules to prevent the inappropriate use of a bilateral tax treaty by residents of third countries, known as "treaty shopping." Analysis of data from U.S. corporate tax returns indicates that a small subset of U.S. tax treaties that have deficient anti-treaty-shopping protections is being exploited by third-country residents. Thus, these treaties present an unusual opportunity to observe taxpayer behavior in the absence of anti-abuse provisions, and indirectly provide evidence that the anti-treaty-shopping provisions in the other U.S. agreements are an effective deterrent against abuse. The Treasury Department is actively taking steps to amend or replace the deficient agreements, and to fortify the limitation-on-benefits provisions where needed throughout the U.S. tax-treaty network.

C. Development of the Anti-Abuse Provisions of U.S. Tax Treaties

Through its network of 58 income tax treaties encompassing 66 countries, the United States seeks to minimize tax-related impediments to inbound foreign investment by reducing, and in many cases waiving, its statutory taxing rights on U.S.-source income earned by residents of its treaty partners. For a variety of reasons (such as irreconcilable policy differences, the absence of problems that require resolution through a tax treaty, or low levels of cross-border investment), the United States does not have tax treaties with many countries. Accordingly, residents of those third countries are subject to U.S. taxation as prescribed under the Code on income from their investments in the United States. For instance, absent a treaty providing otherwise, the United States generally imposes a 30-percent gross-basis withholding tax on payments of dividends, royalties, and many types of interest earned by nonresidents who do not have a U.S. trade or business.

Because tax treaties are negotiated agreements between two countries, it is necessary to ensure that the benefits they provide, such as reductions in statutory withholding rates, are not abused. Curtailing inappropriate reductions in withholding rates is an underlying principle of many aspects of modern U.S. tax-treaty policy as formulated by the Treasury Department, and embodied in the United States Model Income Tax Convention of November 15, 2006 ("2006 U.S. Model") and all of the income tax treaties recently concluded by the Treasury Department. Safeguards against inappropriate withholding reductions are perhaps most noteworthy in the context of the provisions regarding cross-border payments of dividends, interest, and insurance premiums, as discussed in detail in sections 1 through 3 below. Section 4 discusses the evolution of the Treasury Department's efforts to combat "treaty shopping," or the inappropriate exploitation of bilateral treaty benefits by a resident of a third country.

1. U.S. Treaty Measures to Prevent Abuse of Dividend-Withholding Reductions

U.S. income tax treaties customarily provide two different withholding-rate reductions for cross-border payments of dividends. Withholding on dividends paid to portfolio investors (defined as shareholders owning less than 10 percent of the shares of the corporation paying the dividend) is typically limited to 15 percent of the gross amount of the dividend. Withholding on dividends paid to direct investors (defined as shareholders owning at least 10 percent of the shares of the corporation paying the dividend) is typically limited to 5 percent of the gross amount of the dividend.

For a number of years, U.S. tax-treaty policy has provided special rules that deny the 5-percent reduced withholding rate on dividends paid by RICs and REITs and permit the 15-percent reduced withholding rate on dividends paid by REITs only in certain instances. These special rules, found in modern U.S. tax treaties, are intended to prevent the use of these entities to gain inappropriate U.S. tax benefits. For example, a corporation resident in the treaty partner that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and would bear a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. Absent the special rule, a RIC could be used to transform portfolio

dividends, taxable in the United States under the treaty at the 15 percent rate of withholding tax, into direct investment dividends taxable at the 5 percent rate of withholding tax.

Similarly, a resident of the treaty partner directly holding U.S. real property would pay U.S. tax upon the sale of the property either at a 30-percent rate of withholding tax on the gross income or at graduated rates on the net income. By placing the real property in a REIT, the investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates generally applicable to dividends, significantly reducing the U.S. tax that otherwise would be imposed on income from real property. The special rule prevents this result and thereby avoids a disparity between the taxation of direct real-estate investments and real-estate investments made through REIT conduits. The special rule, however, permits portfolio investors in a REIT to be eligible for the 15-percent maximum rate of withholding tax on dividends from the REIT.

A number of recent U.S. income tax treaties have provided for an exemption from source-country withholding for certain intercompany dividend payments at prescribed ownership thresholds. The Treasury Department agrees to eliminate withholding taxes on intercompany dividends only in appropriate circumstances. In all cases where such a provision has been included, accompanying safeguards are included to ensure that the provision will not be exploited by persons who were not intended to enjoy the benefit. For example, the benefit is extended only to corporations that satisfy particular tests of the limitation-on-benefits provision, the purpose of which, as is explained more fully below, is to ensure that persons who are not truly residents of the treaty partner do not enjoy the benefits of the treaty.

2. U.S. Treaty Measures to Prevent Abuse of Interest-Withholding Reductions

Over the past decade, financial intermediaries have developed a variety of new financial products that do not fit well within the traditional definitions and concepts of debt and equity upon which the tax-treaty framework has relied. Although taxpayers generally use these new financial instruments for legitimate business reasons, there is a growing concern that they also may be used for tax-avoidance purposes. For example, it is apparent that taxpayers can use derivative instruments to replicate an equity investment and to earn income that is virtually indistinguishable from a dividend. If withholding tax is not imposed on these payments, it would be a simple matter for nonresidents to receive a dividend-like return without being subject to the withholding tax that would apply to actual dividends.

In view of the foregoing, the Treasury Department places importance on preserving maximum flexibility for the United States to deal with the evolving market of financial products and to treat the income they generate as dividends or as interest if that treatment is consistent with internal law. On the other hand, it also is important to ensure that withholding taxes do not hinder the use of those instruments for hedging or other legitimate business purposes.

The 2006 U.S. Model includes a special rule in the interest article that preserves the right of the United States to tax interest payments that are contingent on the debtor's

(or a related person's) income (e.g., receipts, sales or other cash flow, profits, or changes in the value of property) or payments (e.g., dividends or partnership distributions), so-called "contingent interest," at a rate of 15 percent of the gross amount of the interest. Under U.S. tax law, instruments that are denominated as debt instruments but that participate in profits may be respected as indebtedness or may be recharacterized as equity, depending on the terms of the instrument.

Even if an instrument is respected as indebtedness for U.S. tax purposes, contingent interest generally will not qualify for the exemption from U.S. withholding tax that applies to "portfolio interest" received by a foreign person. Most other types of U.S.-source interest qualify as "portfolio interest," unless the interest is beneficially owned by a person that is related to the payor or is beneficially owned by a foreign bank that has made a loan in the ordinary course of its trade or business. The contingent-interest rules were added to the Code in 1993 to deal with specific types of abuses in which foreign taxpayers could avoid the taxes imposed on investments in U.S. real property or could avoid the withholding taxes on dividends by making economically equivalent payments with respect to instruments that would otherwise qualify as debt. Modern U.S. tax treaties preserve these special tax rules for payments of contingent interest.[78]

The 2006 U.S. Model and recent U.S. tax treaties similarly preserve anti-abuse rules regarding holdings by foreign persons in U.S. Real Estate Mortgage Investment Conduits (REMICs). REMICs are a popular U.S. tax vehicle that hold a fixed pool of real estate loans and issue debt securities with serial maturities and differing seniority and rates of return (referred to as "regular interests") backed by those loans. Through a REMIC, a financial institution can repackage and sell long-term mortgages to investors.

A REMIC is not subject to U.S. income tax. Instead, holders of a REMIC's "residual interests" include in income their share of the REMIC's net taxable income or loss each year. Although cash flow from the REMIC's mortgage assets is used almost exclusively to service payment obligations with respect to the regular interests it has issued, ordinarily there is a mismatch in the tax character of payments received and payments made. For example, in a REMIC's early years, payments of taxable interest received with respect to mortgage assets might be used to make nondeductible payments of principal with respect to a shorter-maturity regular interest. In such a case, the holder of a residual interest could have "phantom income," or taxable income without accompanying distributions of cash. This situation reverses in the REMIC's later years, when cash received from mortgage assets consists largely of nontaxable repayments of principal but the payments with respect to outstanding regular interests consist primarily of deductible payments of interest.

If the present value of expected cash flows from a REMIC residual interest exceeds the present value of the tax liability that is expected to arise as a result of "phantom income" (followed by "phantom deductions" in later years), the residual interest may be an economically valuable asset. However, if the present value of the expected cash flows is less than the present value of the tax liability, the REMIC residual interest has a net liability, and a potential holder would require a payment to compensate for the negative value.

---

[78]See Article 11(2)(b) of the 2006 U.S. Model.

Income with respect to a residual interest generally is treated as interest income under U.S. law. If a REMIC residual interest is owned by a nonresident, the share of REMIC income that is attributable to a normal return (120 percent of the long-term Treasury bond rate) on the nonresident's cash investment in the REMIC is treated as "portfolio interest" and is exempt from U.S. withholding. The return in excess of this amount is known as an "excess inclusion."

The special nature of REMIC residual interests – phantom income in early years followed by phantom deductions in later years – creates incentives both to escape taxation of the excess inclusion and to use subsequent phantom deductions to offset U.S. taxable income. Congress recognized this potential and created rules designed to ensure that excess inclusions remain subject to U.S. tax, whether held by or otherwise transferred to entities not subject to U.S. tax. Absent a full tax at source, inappropriate reductions in U.S. withholding taxes could result with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests. Accordingly, in order to prevent such abuses, modern U.S. tax treaties preserve the ability of the United States to apply its domestic law to REMIC residual interests.[79]

3. Measures to Ensure Against Abuses of Treaty-Imposed Waivers of the Federal Excise Tax on Insurance Premiums Paid to Foreign Insurers

The Treasury Department is commonly asked by countries, in the context of bilateral negotiations, to include the Federal excise tax on insurance premiums paid to foreign insurers as a "covered tax" for purposes of a treaty. The effect of including this tax as a covered tax is that the United States generally would not be allowed to impose the tax on premiums paid to an insurance company resident in the treaty partner, unless that corporation had a permanent establishment in the United States.

The Senate Foreign Relations Committee has expressed concerns that the treatment of the federal insurance excise tax as a covered tax may put U.S. insurers at a competitive disadvantage with respect to foreign competitors in the U.S. market if substantial tax is not imposed by the treaty partner on the insurance income of the foreign insurer.[80] Moreover, in cases where the foreign premium income bears little or no tax in the other country, treatment of the insurance excise tax as a covered tax would create instances of double non-taxation.

In response to these concerns, if a country expresses interest in including the insurance excise tax as a covered tax in a treaty, the Treasury Department conducts a thorough review of the taxation of the insurance industry in the prospective treaty partner. The Treasury Department agrees to cover this tax, and thereby grant an exemption from this tax, only if satisfied that an insurance company resident in the treaty partner and insuring U.S. risks would face a level of taxation that is substantial relative to the level of taxation faced by U.S. insurers. For a number of years the Treasury Department has employed a particular methodology to analyze a prospective treaty partner's taxation of its insurance companies. The central component of the analysis includes a number of effective tax rate calculations and comparisons to determine if insurance companies in the

[79]See Article 11(2)(c) of the 2006 U.S. Model.
[80]See, e.g., S. Exec. Rpt. 106-8, Italy: 1999 Income Tax Convention.

prospective treaty partner face a tax burden comparable to their counterparts in the United States.

4. Abuses of Bilateral Income Tax Treaties by Third-Country Residents and the Development of the Limitation-on-Benefits Concept

Through its tax-treaty network the United States seeks to minimize tax-related impediments to inbound foreign investment by reducing, and in many cases waiving, its statutory taxing rights on U.S.-source income earned by residents of its treaty partners. However, tax treaties are negotiated agreements between two countries and, consequently, it is necessary to ensure that the benefits tax treaties provide, such as reductions in statutory withholding rates, are not abused. Residents of non-treaty countries may seek ways of lowering the tax cost of their investments in the United States. This result could be achieved by routing the investment through an entity that has been established in a country that has an income tax treaty with the United States. By establishing such a structure, the third-country resident can obtain the benefits of the bilateral treaty. This abuse of a bilateral agreement by third-country residents is commonly referred to as "treaty shopping."

As stated in the United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, it has been the long-held belief of the United States that the benefits of an income tax treaty should be conferred only to the residents of the two countries party to the agreement. As a policy matter, tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes in a particular treaty mean that U.S. persons pay less tax to the other country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents are able to exploit a tax treaty to secure reductions in U.S. tax, the benefits would flow only in one direction as third-country residents would enjoy U.S. tax reductions for their U.S. investments, but U.S. residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home country's tax systems and policies and those of the United States. Preventing this exploitation of U.S. tax treaties is critical to ensuring that the third country will negotiate with the United States on a reciprocal basis, so that U.S. persons can receive the benefits of reductions in source-country tax on their investments in that country.

It should be noted that in some cases, third-country residents may establish entities in the treaty partner for legitimate business reasons. An effective anti-treaty shopping rule should separate those cases from the abusive situations in which the primary reason for establishing the entity is to obtain treaty benefits. It is difficult to prove that a particular structure or transaction was motivated by tax-avoidance reasons, thus making anti-abuse rules based on subjective determinations of the taxpayer's motives difficult to administer.[81]

[81]Moreover, in 1999 the Senate Foreign Relations Committee expressed a preference for an objective approach in the context of its consideration of the tax treaties with Slovenia and Italy.

Development of the Limitation-on-Benefits Concept

Recognizing the shortcomings of subjective anti-abuse rules, the United States has developed a series of objective tests, known as Limitation on Benefits ("LOB") provisions, which are intended to determine whether a person is sufficiently connected economically to the treaty partner to warrant receiving treaty benefits. The United States has included LOB provisions in its income tax treaties dating back to 1970, although the provisions have evolved and become increasingly sophisticated over time. The earliest versions, called Investment Holding Company provisions (Egypt (1981), Korea (1979), Norway (1972), Morocco (1981), and Trinidad and Tobago (1970)), deny benefits to a corporation that is greater than 25-percent owned by individuals not resident in that state, and which by reason of special measures faces an effective tax rate substantially lower than the generally imposed tax rate.[82]

Later U.S. tax treaties included additional objective tests to determine a person's level of economic nexus to its country of residence. A number of agreements (Cyprus (1985), Indonesia (1990), and Jamaica (1981)) supplemented the ownership test by also requiring that a corporation's gross income not be used "in substantial part" to satisfy liabilities to nonresidents. This rule was a precursor to the modern "ownership/base-erosion" test in the 2006 U.S. Model LOB provision. The ownership/base-erosion test denies treaty benefits to corporations that are majority owned by third-country residents or that disburse more than half of their gross income in the form of certain deductible payments to third-country residents.

In addition, because widely held corporations are not likely vehicles for treaty shopping, several U.S. tax treaties also granted benefits to corporations publicly traded on a recognized stock exchange, as prescribed in the particular treaty. This "publicly traded" test, which has evolved over time as discussed below, has become one of the fundamental components of modern LOB provisions.

Another cornerstone of the 2006 U.S. Model LOB, the "active-conduct" test, grants benefits to a corporation that did not satisfy the publicly traded or ownership/base-erosion tests. Under the active-conduct test, a corporation will be eligible for treaty benefits if it satisfies two conditions: (1) it is engaged in the active conduct of a trade or business in its country of residence; and (2) the payment for which benefits are sought is related to the trade or business. In certain cases, an additional requirement that the trade or business be substantial in size relative to the activity in the source country generating the income must be met.

Collectively, the publicly traded, active-conduct, and ownership/base-erosion tests form the core of today's LOB provisions. Typically, the LOB also grants the competent authorities the discretion to grant treaty benefits in instances in which the competent authorities conclude that treaty benefits are appropriate.

While the United States has been a leader in this aspect of tax-treaty policy, tax authorities around the globe have also increased their efforts to combat treaty shopping.

---

[82]Subsequent LOB provisions further developed the concept of ownership while de-emphasizing the effective tax rate faced by the corporation, but where appropriate, U.S. tax treaties deny benefits to corporations that benefit from preferential tax treatment in the other country by virtue of special regimes (Barbados (2004)).

For instance, the Commentaries to the Model Income Tax Convention of the Organisation for Economic Cooperation and Development were amended in 2003 to include a template LOB provision that countries could include in their bilateral agreements if they wished to do so.

Refinements to LOB Rules in the 2006 U.S. Model – Corporate Expatriations and the Publicly Traded Test

Under the publicly traded test, certain public corporations satisfy the applicable LOB provision and, thus, qualify for treaty benefits. In two recent protocols, the Treasury Department has revised the publicly traded test in response to particular developments in cross-border activity between the United States and the treaty partner. In both cases, the changes represent a further refinement of this test to ensure that the underlying objectives of the LOB provision are achieved.

In its original form, the publicly traded test focused on corporations that were regularly traded on the stock markets in their home country and reflected the view that such corporations likely would not be used by residents of third countries for treaty-shopping purposes. The parameters of the test evolved with changes in the global financial markets. With the growth of regional markets, corporations that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign corporations are listed and substantially traded on U.S. exchanges. The publicly traded test has been structured to take into account both home-country trading and also U.S. and regional third-country trading to reflect the realities of modern global financial markets. However, it has become clear that, in some circumstances, additional nexus between the corporation and its country of residence is necessary to effect the underlying objective of the LOB provision.

The U.S.-Barbados protocol (2004) was negotiated to prevent the potential for exploitation of the U.S.-Barbados treaty by U.S. corporations seeking inappropriate U.S. tax reductions. In the years prior to the conclusion of the protocol, a small number of U.S. corporations engaged in corporate-inversion transactions, which involve a complicated restructuring in which a new foreign corporation is interposed between the public shareholders and the existing U.S. parent corporation. This restructuring was used to take advantage of U.S. tax rules to reduce U.S. tax on income from the corporate group's U.S. operations and also to reduce U.S. tax on income from any foreign operations of the corporate group. In some corporate-inversion transactions, the new foreign "parent" corporation claimed to be a resident of Barbados so that the provisions of the U.S.-Barbados treaty could be used to reduce U.S. tax on payments from the existing U.S. corporate group to the new Barbados parent corporation. The use of the treaty in connection with this sort of corporate-inversion transaction was neither intended nor appropriate. More generally, the treaty was not intended to be used by corporations that while technically resident in Barbados do not have sufficient nexus with Barbados.

The protocol curtails this inappropriate exploitation of the treaty through modifications to the LOB provision. In particular, the protocol tightens the publicly traded test to ensure that a corporation resident in Barbados must have a real nexus with

Barbados in order to be eligible for treaty benefits. This nexus is established through the requirement that the corporation's stock not only be listed on the Barbados stock exchange but also be primarily traded on the Barbados stock exchange (or on the complementary exchanges in Jamaica or Trinidad and Tobago). As a result of the protocol's changes to the LOB provision, a Barbados corporation that is largely traded on a U.S. stock exchange, which is the case for the corporations that have undertaken corporate-inversion transactions, will no longer qualify for benefits under the U.S.-Barbados tax treaty.

The U.S.-Netherlands protocol (2004) constitutes an overhaul of the LOB provision in the 1993 U.S.-Netherlands treaty. It is notable that the 1993 U.S.-Netherlands treaty broke new ground in terms of comprehensive anti-treaty shopping rules and the inclusion of the LOB provision in that treaty was crucial to the Treasury Department's success in negotiating such provisions with other countries. The refinements included in the new protocol reflect experience gained both through the administration of the LOB provision in the 1993 treaty and through the crafting of similar provisions in more recent treaties.

The U.S.-Netherlands protocol also included a new approach for the publicly traded test, designed to ensure the intended nexus between a publicly traded corporation and its country of residence while recognizing the integration of the global financial markets. Under this formulation, a public corporation that does not have sufficient nexus to its residence country through trading on the stock exchanges in that country must establish nexus through primary management and control in its residence country to qualify for treaty benefits under the publicly traded test. Thus, for example, a Netherlands corporation that has more trading of its shares on U.S. stock exchanges than on exchanges in the Netherlands and its economic region or whose shares otherwise are overwhelmingly traded on exchanges outside the Netherlands will qualify for U.S. treaty benefits under this new test if the corporation's center of management and control is in the Netherlands (which establishes a real link between the corporation and the Netherlands). Given developments in trading patterns, the new publicly traded test better serves the intended purpose of limiting treaty shopping by third-country residents. Moreover, the revisions to the test are intended to be forward looking, to prevent any potential for the U.S.-Netherlands treaty to be exploited by a U.S. corporation in possible future evolution of corporate-inversion type transactions.

In negotiating publicly traded tests requiring listing and primary trading of a corporation's principal class of shares on a recognized stock exchange located in the corporation's state of residence, the Treasury Department has encountered concerns from many countries with small native stock exchanges that such a rule would be too restrictive. These countries argue that their corporations should not be penalized just because they do not have access to equity capital in their home country. In response to these concerns the Treasury Department further modified the publicly traded test, as is found in recent agreements with Belgium (2006), Bulgaria (2006), Denmark (2005), Finland (2005), Germany (2005), Sweden (2005), and the 2006 U.S. Model. The new formulation requires either that the corporation's principal class of shares be primarily traded on a stock exchange in its country of residence, or that the corporation's primary place of management and control be in its country of residence. The term "primary place

of management and control" is defined as the country where the corporation's executive officers and senior management employees exercise the most day-to-day responsibility for the strategic, financial, and operational decision making of the corporation, and where the most day-to-day activities necessary for preparing and making those decisions take place.

D. Identification of Inappropriate Reductions in U.S. Withholding Taxes that Provide Opportunities for Shifting Income Out of the United States, and Evaluation of Whether Existing Anti-Abuse Mechanisms Are Operating Properly

In evaluating potential opportunities for treaty shopping and the effectiveness of the LOB anti-abuse measures, two categories of tax treaties within the U.S. network merit special attention: (1) those that do not have any type of LOB provision; and (2) those that provide a low or zero rate of tax on certain payments, in particular deductible payments such as interest. The U.S. treaties that fall into both of these categories are those through which treaty shopping would be the easiest and most profitable. The current U.S. treaties with no LOB protection are the agreements with Greece (1953), Hungary (1979), Iceland (1975), Pakistan (1959), the Philippines (1982), Poland (1976), Romania (1976) and the U.S.S.R. (1976)[83]. Of these, zero-rate withholding provisions on interest[84] in the treaties with Iceland, Poland, and Hungary make those the most attractive treaty-shopping candidates.[85] Accordingly, use of these three agreements may be valuable indicators of treaty-shopping behavior that could take place in the absence of adequate anti-abuse measures.

1. Data from U.S. Corporate Tax Returns

Transactional data compiled from Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a Trade or Business," provide some suggestive evidence regarding the potential extent of abuse of these three agreements by third-country residents. U.S. corporations that are at least 25-percent foreign-owned are required to report on Form 5472 all of their transactions with related parties in other countries.[86] Table 4.1 presents data from Form 5472 on interest payments from U.S. corporations that are at least 25-percent foreign owned to related foreign parties for the top 20 countries of residence of the foreign party for 1996, the earliest year for which the IRS has readily accessible data. With a few exceptions, this

---

[83]The U.S.-U.S.S.R. income tax treaty applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[84]Interest is a popular tool for treaty-shopping abuses for two reasons. First, the interest payment generates a deductible expense. Second, it is often easier to route interest through a corporation that has been set up in the treaty jurisdiction for the purpose of obtaining treaty benefits for the payment than it is to route many other types of payments.

[85]While the tax treaty with Greece provides a zero rate of withholding on interest, restrictions apply that prevent, for instance, a Greek company receiving interest from a U.S. company from obtaining the zero rate if the Greek company controls, directly or indirectly, more than 50 percent of the U.S. company paying the interest.

[86]For purposes of Form 5472, the term "related party" is defined as any direct or indirect foreign shareholder of the reporting corporation, any person who is related (within the meaning of section 267(b) or 707(b)(1)) to a 25-percent foreign shareholder of the reporting corporation, or any other person who is related to the reporting corporation within the meaning of section 482 and the related regulations.

top stratum contains the most significant trade and investment partners of the United States.

Table 4.2 presents data on interest payments made by U.S. corporations that are at least 25-percent foreign owned to related parties in Iceland and Hungary for 1996 through 2004.[87] Neither Iceland nor Hungary ranked within the top 20 recipient countries of related-party interest in 1996, but ranked seventh and eighth by 2004, higher than major investment partners such as Canada and Japan, as is shown in Table 4.3 below.[88] Payments of interest to related parties in Iceland increased exponentially, from $0.3 million in 1996 to $912.7 million in 2004. A similarly dramatic increase of interest payments to related parties in Hungary occurred, from $197.5 million in 2000 to $1.24 billion in 2004. The data indicate that Poland has not yet experienced such growth in interest payments from related U.S. corporations. Poland did not appear within the top 50 recipient countries of related-party interest until 2004, when it ranked 35th, with $1.4 million.

2. Ultimate Parent Ownership

The substantial increase in interest paid by U.S. corporations that are at least 25-percent foreign owned to related Icelandic and Hungarian corporations in recent years, while noteworthy, is not by itself conclusive evidence of treaty-shopping abuse. However, information from publicly available corporate profiles reveals that many of the Icelandic and Hungarian related parties are owned by parent corporations from third countries.

A third-country corporation may have an incentive to engage in treaty shopping if the tax treaty between the United States and its country of residence only reduces, but does not eliminate, withholding taxes on interest. Alternatively, the country of residence may simply not have a tax treaty in force with the United States, in which case a U.S.-source payment to the third-country corporation may be subject to gross-basis withholding at 30 percent. Accordingly, it is advantageous from a tax perspective for the third-country corporation to structure a loan through an Icelandic or Hungarian entity for three reasons. First, no U.S. withholding tax is imposed on the interest by virtue of the U.S.-Iceland and U.S.-Hungary tax treaties. Second, taxation of the payments by Iceland or Hungary may be reduced or avoided through tax incentives, special regimes,[89] or other arrangements. Finally, if the payment is not taxed currently by the third country, the interest will bear no tax in the source, conduit, or residence jurisdictions.

[87]Data from Form 5472 are only available for the even-numbered years shown.

[88]Data on the stock of foreign direct investment in the United States, compiled by the Commerce Department's Bureau of Economic Analysis (BEA) are consistent with the corporate tax return data. BEA defines "direct investment" as a holding of at least 10 percent of the shares of a corporation. Iceland and Hungary figure fairly prominently, ranking 17th and 13th, respectively, in terms of foreign direct investment in the United States.

[89]Presently, a number of special regimes such as Iceland's International Trading Companies and Hungary's offshore corporations have been repealed or are phasing out, although in Hungary 100-percent tax credits for certain investments will continue to be available until 2011.

Table 4.1

Interest Payments from Foreign-Controlled U.S. Corporations to Foreign Related Parties, Ranked by Country of Residence of Foreign Related Party: 1996

Country	Interest Paid by U.S. Corporations to Related Foreign Persons ($ millions)	Number of Foreign Related Persons	Rank (by Amount of Interest Paid)
United Kingdom	3,009.8	1,282	1
Netherlands	1,092.4	516	2
France	742.8	636	3
Germany	699.6	757	4
Luxembourg	681.0	31	5
Ireland	567.7	107	6
Canada	433.3	602	7
Japan	421.9	616	8
Netherlands Antilles	417.9	35	9
Switzerland	186.7	310	10
Sweden	87.3	321	11
Finland	85.6	123	12
Singapore	78.1	279	13
Bermuda	67.2	74	14
Denmark	41.2	95	15
Hong Kong	39.4	277	16
Australia	34.3	385	17
Barbados	27.6	25	18
Puerto Rico	16.6	184	19
Belgium	15.8	241	20

Table 4.2 Interest Paid to Related Parties in Iceland and Hungary: 1996 - 2004						
Year	Interest Paid by U.S. Corporations to Related Parties in Iceland			Interest Paid by U.S. Corporations to Related Parties in Hungary		
	Amount ($millions)	Number of Foreign Related Persons	Rank (by Amount of Interest Paid)	Amount ($ millions)	Number of Foreign Related Persons	Rank (by Amount of Interest Paid)
1996	0	0	N/A	0	26	40
1998	0.3	2	37	50	45	5
2000	63.7	5	18	197.5	37	13
2002	643.6	12	9	1,179.8	111	7
2004	912.7	18	8	1,238.1	137	7

A more definitive conclusion that treaty shopping has taken place would depend upon whether the Icelandic or Hungarian subsidiaries of third-country parent corporations would fail standard LOB tests. If they are wholly owned and controlled by the third-country parent, the Icelandic or Hungarian corporations would not likely satisfy the requirements for subsidiaries of publicly traded corporations or the ownership/base-erosion test. In order to qualify under the "active conduct" test, the corporations would need to be engaged in a trade or business in Iceland or Hungary, respectively; the payment from the United States would have to be related to the Icelandic or Hungarian trade or business; and the Icelandic or Hungarian trade or business would have to be substantial in size relative to the U.S. activity generating the payment.

Table 4.3

Interest Payments from Foreign-Controlled U.S. Corporations to Foreign Related Parties, Ranked by Country of Residence of Foreign Related Party: 2004

Country	Interest Paid by U.S. Corporations to Related Foreign Persons ($ millions)	Number of Foreign Related Persons	Rank (by Amount of Interest Paid)
United Kingdom	6,745.7	1,608	1
Switzerland	6,421.3	438	2
Netherlands	3,068.4	619	3
Luxembourg	1,468.2	103	4
Germany	1,351.2	1,269	5
France	1,328.8	1,032	6
Hungary	*1,238.1*	*137*	*7*
Iceland	*912.7*	*18*	*8*
Belgium	591.5	326	9
Ireland	460.4	235	10
Canada	381.5	905	11
Sweden	328.2	430	12
Cayman Islands	325.5	69	13
Barbados	323.0	54	14
Bermuda	134.9	132	15
Japan	74.6	1,004	16
Austria	41.6	126	17
Finland	39.7	171	18
Hong Kong	36.6	336	19
Mexico	36.1	608	20

The number of related persons in Hungary (137) and Iceland (18) suggests that as of 2004, a limited number of taxpayers are engaged in treaty-shopping abuses of the Hungary and Iceland agreements (compare this to the number of related parties in Germany (1,269) and France (1,032)). Nevertheless, as Table 4.2 demonstrates, the size in dollar terms of the potential treaty abuse is significant.

E. Conclusions

1. Effectiveness of Measures to Avoid Abuses of Withholding Taxes on Dividends, Interest and Insurance Premiums

Through its network of bilateral income tax treaties, the United States seeks to minimize tax-related impediments to inbound foreign investment by reducing, and in many cases waiving, its statutory taxing rights on U.S.-source income earned by residents of its treaty partners. However, tax treaties are negotiated agreements between two countries and, consequently, it is necessary to ensure that the benefits they provide, such as reductions in statutory withholding rates, are not abused. The Treasury Department develops tax-treaty policy to ensure that inappropriate reductions of withholding taxes provided in treaties are avoided. In many instances, treaty policy was crafted in consultation with the Congress, as was the case with the special rules governing dividends paid by RICs and REITs, excess inclusions with respect to residual interests in REMICs, payments of contingent interest, and the methodology for analyzing potential waivers of the Federal excise tax on insurance premiums in bilateral agreements. The Treasury Department is confident that these anti-abuse rules achieve the appropriate balance of preventing inappropriate reductions of withholding taxes while at the same time allowing cross-border economic activity to reach its full potential.

2. Effectiveness of Measures to Combat Treaty Shopping

A growing consensus is developing among tax authorities worldwide about the need to prevent third-country residents from inappropriately obtaining the benefits of bilateral income tax treaties. The United States has been a leader in combating treaty shopping with objective LOB provisions intended to deny treaty benefits to persons with an insufficient business and economic nexus to the treaty partner. The evolutionary nature of tax planning and treaty shopping similarly requires that LOB provisions adapt with time to prevent abusive structures from developing. For instance, the rise of abusive corporate-inversion structures has necessitated fortifying the U.S. approach to combat treaty shopping.

The contributing role of a few U.S. tax treaties in facilitating corporate expatriations from the United States prompted the Treasury Department to adjust some of the objective tests of standard LOB provisions, in particular the publicly traded test. Revised publicly traded tests were introduced in the 2004 protocols to the U.S.-Barbados and U.S.-Netherlands treaties. More recently, a revised test has been incorporated in the U.S. tax treaties with Belgium (2006), Bulgaria (2006), Denmark (2005), Finland (2005), Germany (2005), and Sweden (2005).

It is difficult to measure the effect of anti-abuse provisions, and the LOB rules are no exception. However, a number of agreements in the U.S. tax-treaty network, namely

those with Iceland, Hungary and Poland, are unique in that they provide significant source-country benefits (in particular a complete exemption of all interest payments) and also do not have any anti-treaty shopping protections. Thus, these treaties present the opportunity to observe taxpayer behavior in the absence of an LOB provision.

Data compiled from U.S. corporate tax returns show that in recent years the amounts of interest payments from foreign-controlled U.S. corporations to related parties in Iceland and Hungary have increased dramatically. In 1996, no U.S.-source interest was reportedly paid by foreign-controlled U.S. companies to their related parties in Iceland, and insignificant amounts of interest was paid to related parties in Hungary. However, by 2004, those amounts had increased exponentially. Moreover, a preponderance of the Icelandic and Hungarian entities were ultimately owned by corporations from third countries. The evidence on treaty shopping through the Iceland and Hungary treaties suggests that the LOB provisions in the other U.S. agreements provide deterrence against abuse.

F. The Treasury Department's Most Recent Efforts to Combat Abuse of Tax Treaties

A chief objective of the Treasury Department's tax-treaty program is to protect the U.S. tax-treaty network from abuse. The Treasury Department has taken many steps towards achieving that goal. The 2006 U.S. Model contains an improved LOB provision that the Treasury Department developed over the course of its recent tax-treaty negotiations. A noteworthy enhancement of the new LOB provision is a publicly traded test reformulated to thwart corporate expatriations. This revised rule will form the starting point for future U.S. tax-treaty negotiations.

The Treasury Department has also taken steps to revise those U.S. tax treaties that are most vulnerable to treaty shopping. In this regard, the signing of a new income tax treaty between the United States and Iceland in October 2007 is especially significant. The new agreement with Iceland reflects current tax treaty policies of both countries, and includes a comprehensive limitation on benefits provision intended to ensure that only residents of the United States and Iceland will enjoy the benefits of the agreement. Additionally, further treaty negotiations with Hungary are scheduled for the second half of 2007. As of 2004, it does not appear that the U.S.-Poland tax treaty has been extensively exploited by third-country residents. Nevertheless, the Treasury Department anticipates commencing negotiations with Poland in 2007 to conclude a new tax treaty to replace the 1976 agreement. The United States places a high priority on bringing the new Iceland tax treaty into force and on concluding as soon as possible the negotiations with Hungary and Poland.

Beyond focusing on renegotiating the three treaties described above, the Treasury Department reviews, on a continuing basis, the current U.S. tax-treaty network to identify deficiencies in existing agreements and areas where more beneficial terms for U.S. taxpayers could be negotiated. As part of this process, anti-treaty-shopping provisions are given special scrutiny to ensure that they are functioning appropriately. Those treaties with LOB provisions that are out of date or need strengthening are given higher priority in the Treasury Department's plan for negotiations.

G. Appendices

1. Limitation on Benefits Provision from 2006 U.S. Model

Article 22

LIMITATION ON BENEFITS

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2.

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:

a) an individual;

b) a Contracting State, or a political subdivision or local authority thereof;

c) a company, if:

i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either:

A) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or

B) the company's primary place of management and control is in the Contracting State of which it is a resident; or

ii) at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under clause i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

d) a person described in paragraph 2 of Article 4 of this Convention, provided that, in the case of a person described in subparagraph a) of that paragraph, more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or

e) a person other than an individual, if:

i) on at least half the days of the taxable year, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State, and

ii) less than 50 percent of the person's gross income for the taxable year, as determined in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

3. a) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income derived from the other State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.

b) If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a related person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or such person in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

c) For purposes of applying this paragraph, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

4. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, if it determines that the establishment, acquisition or maintenance of

such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.

5. For purposes of this Article:

a) the term "recognized stock exchange" means:

i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange - under the U.S. Securities Exchange Act of 1934;

ii) stock exchanges of -------; and

iii) any other stock exchange agreed upon by the competent authorities;

b) the term "principal class of shares" means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company;

c) the term "disproportionate class of shares" means any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company; and

d) a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other state.

2. Technical Explanation to 2006 Model Article 22 (Limitation on Benefits)

ARTICLE 22 (LIMITATION ON BENEFITS)

Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.

The structure of the Article is as follows: Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent

provided in the Article. Paragraph 2 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to all the benefits of the Convention. Paragraph 3 provides that, regardless of whether a person qualifies for benefits under paragraph 2, benefits may be granted to that person with regard to certain income earned in the conduct of an active trade or business. Paragraph 4 provides that benefits also may be granted if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 5 defines certain terms used in the Article.

Paragraph 1

Paragraph 1 provides that a resident of a Contracting State will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only to the extent provided in the Article. The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 21, the treaty-based relief from double taxation provided by Article 23, and the protection afforded to residents of a Contracting State under Article 24. Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 25 is not limited to residents of the Contracting States, and Article 27 applies to diplomatic agents or consular officials regardless of residence. Article 22 accordingly does not limit the availability of treaty benefits under these provisions.

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Paragraph 2

Paragraph 2 has six subparagraphs, each of which describes a category of residents that are entitled to all benefits of the Convention.

It is intended that the provisions of paragraph 2 will be self executing. Unlike the provisions of paragraph 4, discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Individuals -- Subparagraph 2(a)

Subparagraph (a) provides that individual residents of a Contracting State will be entitled to all treaty benefits. If such an individual receives income as a nominee on behalf of a third country resident, benefits may be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

Governments -- Subparagraph 2(b)

Subparagraph (b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all benefits of the Convention.

Publicly-Traded Corporations -- Subparagraph 2(c)(i)

Subparagraph (c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (i) of subparagraph (c) if the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognized stock exchanges and the company satisfies at least one of the following additional requirements: first, the company's principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or, second, the company's primary place of management and control is in its State of residence.

The term "recognized stock exchange" is defined in subparagraph (a) of paragraph 5. It includes (i) the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; (ii) [certain exchanges located in the other Contracting State]; and (iii) any other stock exchange agreed upon by the competent authorities of the Contracting States.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares". The term "principal class of shares" is defined in subparagraph (b) of paragraph 5 to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50% of the shares, it is only necessary for one such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying, group of shares with more than half of the company's voting power and value could be identified.

A company whose principal class of shares is regularly traded on a recognized stock exchange will nevertheless not qualify for benefits under subparagraph (c) of paragraph 2 if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph (c) of paragraph 5. A company has a disproportionate class of shares if it has outstanding a class of shares which is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in the other Contracting

State meets the test of subparagraph (c) of paragraph 5 if it has outstanding a class of "tracking stock" that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The following example illustrates this result.

Example. OCo is a corporation resident in the other Contracting State. OCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on the principal stock exchange of the other Contracting State. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that OCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of OCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S. source interest income earned by OCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not regularly traded on a recognized stock exchange, OCo will not qualify for benefits under subparagraph (c) of paragraph 2.

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the State from which treaty benefits are sought, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Sections 1.884-5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the Convention.

The regular trading requirement can be met by trading on any recognized exchange or exchanges located in either State. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in the other Contracting State. Authorized but unissued shares are not considered for purposes of this test.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3), relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is "primarily traded" if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the number of shares in the company's principal class of

shares that are traded during that year on established securities markets in any other single foreign country.

A company whose principal class of shares is regularly traded on a recognized exchange but cannot meet the primarily traded test may claim treaty benefits if its primary place of management and control is in its country of residence. This test should be distinguished from the "place of effective management" test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. The company's primary place of management and control will be located in the State in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in that State than in the other State or any third state, and the staff that support the management in making those decisions are also based in that State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the headquarters of the company (that is, the place at which the CEO and other top executives normally are based) be located in the Contracting State of which the company is a resident.

To apply the test, it will be necessary to determine which persons are to be considered "executive officers and senior management employees". In most cases, it will not be necessary to look beyond the executives who are members of the Board of Directors (the "inside directors") in the case of a U.S. company or the members of the [ ] in the case of the other Contracting State. That will not always be the case, however; in fact, the relevant persons may be employees of subsidiaries if those persons make the strategic, financial and operational policy decisions. Moreover, it would be necessary to take into account any special voting arrangements that result in certain board members making certain decisions without the participation of other board members.

Subsidiaries of Publicly-Traded Corporations -- Subparagraph 2(c)(ii)

A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (ii) of subparagraph (c) of paragraph 2 if five or fewer publicly traded companies described in clause (i) are the direct or indirect owners of at least 50 percent of the aggregate vote and value of the company's shares (and at least 50 percent of any disproportionate class of shares). If the publicly-traded companies are indirect owners, however, each of the intermediate companies must be a resident of one of the Contracting States.

Thus, for example, a company that is a resident of the other Contracting State, all the shares of which are owned by another company that is a resident of that State, would qualify for benefits under the Convention if the principal class of shares (and any disproportionate classes of shares) of the parent company are regularly and primarily traded on a recognized stock exchange in that Contracting State. However, such a subsidiary would not qualify for benefits under clause (ii) if the publicly traded parent

company were a resident of a third state, for example, and not a resident of the United States or the other Contracting State. Furthermore, if a parent company in the other Contracting State indirectly owned the bottom-tier company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or the other Contracting State in order for the subsidiary to meet the test in clause (ii).

Tax Exempt Organizations -- Subparagraph 2(d)

Subparagraph 2(d) provides rules by which the tax exempt organizations described in paragraph 2 of Article 4 (Resident) will be entitled to all the benefits of the Convention. A pension fund will qualify for benefits if more than fifty percent of the beneficiaries, members or participants of the organization are individuals resident in either Contracting State. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization. On the other hand, a tax-exempt organization other than a pension fund automatically qualifies for benefits, without regard to the residence of its beneficiaries or members. Entities qualifying under this rule generally are those that are exempt from tax in their State of residence and that are organized and operated exclusively to fulfill religious, charitable, scientific, artistic, cultural, or educational purposes.

Ownership/Base Erosion -- Subparagraph 2(e)

Subparagraph 2(e) provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph (e), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to treaty benefits under subparagraph 2(e).

The ownership prong of the test, under clause (i), requires that 50 percent or more of each class of shares or other beneficial interests in the person is owned, directly or indirectly, on at least half the days of the person's taxable year by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs (a), (b), (d) or clause (i) of subparagraph (c) of paragraph 2. In the case of indirect owners, however, each of the intermediate owners must be a resident of that Contracting State.

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Residence) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 2.

The base erosion prong of clause (ii) of subparagraph (e) is satisfied with respect to a person if less than 50 percent of the person's gross income for the taxable year, as determined under the tax law in the person's State of residence, is paid or accrued to persons who are not residents of either Contracting State entitled to benefits under subparagraphs (a), (b), (d) or clause (i) of subparagraph (c) of paragraph 2, in the form of payments deductible for tax purposes in the payer's State of residence. These amounts do not include arm's-length payments in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. However, depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose.

Paragraph 3

Paragraph 3 sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active trade or business conducted in its State of residence. A resident of a Contracting State may qualify for benefits under paragraph 3 whether or not it also qualifies under paragraph 2.

Subparagraph (a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State. The item of income, however, must be derived in connection with or incidental to that trade or business.

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of the other Contracting State is entitled to the benefits of the Convention under paragraph 3 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company or registered securities dealer but not as part of the company's banking, insurance or dealer business. Because a headquarters operation is in the business of managing investments, a company that functions solely as a

headquarters company will not be considered to be engaged in an active trade or business for purposes of paragraph 3.

An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient.

A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

Example 1. USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of FCo, a corporation resident in the other Contracting State. FCo distributes USCo products in the other Contracting State. Since the business activities conducted by the two corporations involve the same products, FCo's distribution business is considered to form a part of USCo's manufacturing business.

Example 2. The facts are the same as in Example 1, except that USCo does not manufacture. Rather, USCo operates a large research and development facility in the United States that licenses intellectual property to affiliates worldwide, including FCo. FCo and other USCo affiliates then manufacture and market the USCo-designed products in their respective markets. Since the activities conducted by FCo and USCo involve the same product lines, these activities are considered to form a part of the same trade or business.

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

Example 3. Americair is a corporation resident in the United States that operates an international airline. FSub is a wholly-owned subsidiary of Americair resident in the other Contracting State. FSub operates a chain of hotels in the other Contracting State that are located near airports served by Americair flights. Americair frequently sells tour

packages that include air travel to the other Contracting State and lodging at FSub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or businesses. Therefore FSub's business does not form a part of Americair's business. However, FSub's business is considered to be complementary to Americair's business because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.

Example 4. The facts are the same as in Example 3, except that FSub owns an office building in the other Contracting State instead of a hotel chain. No part of Americair's business is conducted through the office building. FSub's business is not considered to form a part of or to be complementary to Americair's business. They are engaged in distinct trades or businesses in separate industries, and there is no economic dependence between the two operations.

Example 5. USFlower is a corporation resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of ForHolding, a corporation resident in the other Contracting State. ForHolding is a holding company that is not engaged in a trade or business. ForHolding owns all the shares of three corporations that are resident in the other Contracting State: ForFlower, ForLawn, and ForFish. ForFlower distributes USFlower flowers under the USFlower trademark in the other State. ForLawn markets a line of lawn care products in the other State under the USFlower trademark. In addition to being sold under the same trademark, ForLawn and ForFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. ForFish imports fish from the United States and distributes it to fish wholesalers in the other State. For purposes of paragraph 3, the business of ForFlower forms a part of the business of USFlower, the business of ForLawn is complementary to the business of USFlower, and the business of ForFish is neither part of nor complementary to that of USFlower.

An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph (b) of paragraph 3 states a further condition to the general rule in subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph (b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (*i.e.*, activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the economies in the two Contracting States.

The determination in subparagraph (b) also is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The application of the substantiality requirement only to income from related parties focuses only on potential abuse cases, and does not hamper certain other kinds of non-abusive activities, even though the income recipient resident in a Contracting State may be very small in relation to the entity generating income in the other Contracting State. For example, if a small U.S. research firm develops a process that it licenses to a very large, unrelated, pharmaceutical manufacturer in the other Contracting State, the size of the U.S. research firm would not have to be tested against the size of the manufacturer. Similarly, a small U.S. bank that makes a loan to a very large unrelated company operating a business in the other Contracting State would not have to pass a substantiality test to receive treaty benefits under Paragraph 3.

Subparagraph (c) of paragraph 3 provides special attribution rules for purposes of applying the substantive rules of subparagraphs (a) and (b). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph (a) that it be engaged in the active conduct of a trade or business and that the item of income is derived in connection with that active trade or business, and for making the comparison required by the "substantiality" requirement in subparagraph (b). Subparagraph (c) attributes to a person activities conducted by persons "connected" to such person. A person ("X") is connected to another person ("Y") if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest in X). For this purpose, X is connected to a company if X owns shares representing fifty percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses fifty percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is fifty percent or more of the aggregate voting power and value or fifty percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

Paragraph 4

Paragraph 4 provides that a resident of one of the States that is not entitled to the benefits of the Convention as a result of paragraphs 1 through 3 still may be granted

benefits under the Convention at the discretion of the competent authority of the State from which benefits are claimed. In making determinations under paragraph 4, that competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Benefits will not be granted, however, solely because a company was established prior to the effective date of a treaty or protocol. In that case a company would still be required to establish to the satisfaction of the Competent Authority clear non-tax business reasons for its formation in a Contracting State, or that the allowance of benefits would not otherwise be contrary to the purposes of the treaty. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 4.

The competent authority's discretion is quite broad. It may grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

For purposes of implementing paragraph 4, a taxpayer will be permitted to present his case to the relevant competent authority for an advance determination based on the facts. In these circumstances, it is also expected that, if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Finally, there may be cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of his State of residence. This would arise, for example, if the benefit it is claiming is provided by the residence country, and not by the source country. So, for example, if a company that is a resident of the United States would like to claim the benefit of the re-sourcing rule of paragraph 3 of Article 23, but it does not meet any of the objective tests of paragraphs 2 and 3, it may apply to the U.S. competent authority for discretionary relief.

Paragraph 5

Paragraph 5 defines several key terms for purposes of Article 22. Each of the defined terms is discussed above in the context in which it is used.

V. REFERENCES

Altshuler, Rosanne, and Harry Grubert (2006). "The Three Parties in the Race to the Bottom: Host Countries, Home Countries, and Multinational Companies." *Tax Notes* (February 27): 979-992.

Angus, Barbara M. (2003). "Testimony Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements," Washington, DC (March 5).

Angus, Barbara M. (2004). "Testimony Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements," Washington, DC (February 25).

Auerbach, Alan J. and Kevin Hassett (1993). "Taxation and Foreign Direct Investment in the United States: A Reconsideration of the Evidence." In Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds. Studies in International Taxation. Chicago: University of Chicago Press.

Baldwin, Robert E. (1995). "The Effects of Trade and Foreign Direct Investment on Employment and Relative Wages." NBER Working Paper No. W5037 (February).

Blouin, Jennifer, Julie Collins, and Douglas Shackelford (2001). "Does Acquisition by Non-U.S. Shareholders Cause U.S. Firms to Pay less Tax?" Paper presented at the International Seminar on Public Economics Conference on Income Taxation and Financial Innovation, Berkley, December.

Brown, Patricia (2006). "Testimony before Senate Committee on Foreign Relations on Pending Income Tax Agreements," Washington, DC (February 2).

Brys, Bert, and Lans Bovenberg (2006). "The Life Cycle of the Firm with Debt and Capital Income Taxes." CentER Discussion Paper No. 2006-91.

Congressional Budget Office (2005), "Taxing Capital Income: Effective Rates and Approaches to Reform." (October). Washington, DC: CBO.

Clausing, Kimbery A. (2001). "The Impact of Transfer Pricing on Intrafirm Trade." In James R. Hines, Jr., ed. *International Taxation and Multinational Activity*. Chicago: University of Chicago Press.

Clausing, Kimbery A. (2006). "International Tax Avoidance and U.S. International Trade." *National Tax Journal* 59(2) (June): 269-287.

Deak, Daniel (2003). *Hungary in International Tax Planning*, Amsterdam: International Bureau of Fiscal Documentation.

The Economist (2006). "America's Dark Materials." (January 19).

Gros, Daniel (2006). "Foreign Investment in the U.S. (II): Being Taken to the Cleaners?" Center for European Policy Studies, Working Document No. 243 (April).

Grubert, Harry (2003). "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location." *National Tax Journal,* 56(1) Part 2, (March): 221-242.

Grubert, Harry (2003). "Another Look at the Low Taxable income of Foreign-Controlled Companies in the United States." Office of Tax Analysis Paper 74, Department of the Treasury (October).

Grubert, Harry (2007). "Debt and the Profitability of Foreign-Controlled Companies in the United States." Forthcoming.

Grubert, Harry, Timothy Goodspeed, and Deborah Swensen (1993). "Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States." In Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds. *Studies in International Taxation*. Chicago: University of Chicago Press.

Grubert, Harry and John Mutti (1991). "Taxes, Tariffs, and Transfer Pricing in Multinational Corporate Decision Making." *Review of Economics and Statistics* 73(2) (May): 285-293.

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.

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): 465-373.

Guttentag, Joseph H (1997). "Testimony Before the Senate Foreign Relations Committee," Washington, DC (October 7).

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,* Supplement 1993 (31): 111-140.

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.

Hines, James R., Jr., and Eric Rice (1994). "Fiscal Paradise: Foreign Tax Havens and American Business." *Quarterly Journal of Economics* 109 (February): 149-182.

Hobbs, James, R. (2006). "Foreign-Controlled Domestic Corporations 2003," *Internal Revenue Service Statistics of Income Bulletin*, Washington, DC (Summer). http//www.irs.gov/taxstats/bustaxstats/article/0,,id=96311,00.html#2.

IBFD (2006). Juhani Kesti, ed., *European Tax Handbook.* Amsterdam: International Bureau of Fiscal Documentation (June).

Jacob, John (1996). "Taxes and Transfer Pricing: Income Shifting and the Volume of Intrafirm Transfers." *Journal of Accounting Research* 34 (2) (Autumn): 301-312.

Joint Committee on Taxation (2003). *The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations*. Washington, DC (July 8).

Joint Committee on Taxation (2005). *Options to Improve Tax Compliance and Reform Tax Expenditures*. Washington, DC (January 27).

Joint Committee on Taxation (2006). "Additional Options to Improve Tax Compliance." Washington, DC (August 3).

Kemsley, Deen (2001). "The Impact of Transfer Pricing on Intrafirm Trade: Comment." In James R. Hines, Jr., ed. *International Taxation and Multinational Activity.* Chicago: University of Chicago Press.

Mintz, Jack and Michael Smart (2004). "Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada." *Journal of Public Economics* 88(6) Special Issue June 2004**:** 1149-1168.

Morris, Will (2006). "Thin Capitalization Limitations." Powerpoint and video presentations at American Enterprise Institute Seminar: "Tax Havens and Foreign Direct Investment," December 11. http:/www.aei.org/events/eventide.1432/event detail.asp#.

OECD (1994). *The Jobs Study: Facts, Analysis, Strategies.* Paris: Organisation for Economic Cooperation and Development.

OECD (2005). *Model Tax Convention on Income and on Capital*. Paris: Organisation for Economic Cooperation and Development.

OECD (2006). *Report on the Attribution of Profits to Permanent Establishments*. Paris: Organisation for Economic Cooperation and Development.

Riker, David and Lael Brainard (1997). "U.S. Multinationals and Competition from Low Wage Countries." NBER Working Paper No. 5959.

Scholes, Myron S. and Mark A. Wolfson (1990). "The Effects of Changes in Tax Laws on Corporate Reorganization Activity." *Journal of Business* 63 (1), Part 2 (January): 141-164.

Seida, Jim A. and William F. Wempe (2004). "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion." *National Tax Journal* 57 (4) (December): 805-828.

Slemrod, Joel (1990). "The Impact of the Tax Reform Act of 1986 on Foreign Direct Investment to and from the United States." In Joel Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986.* Cambridge, MA: MIT Press.

U.S. Bureau of Economic Analysis (1998). *U.S. Direct Investment Abroad: 1994 Benchmark Survey, Final Results.* Washington, DC, May.

U.S. Bureau of Economic Analysis (2004). *U.S. Direct Investment Abroad: Final Results From the 1999 Benchmark Survey.* Washington, DC, April.

U.S. Department of the Treasury, Office of Tax Policy (2000). *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations.* Washington, DC (December).

U.S. Department of the Treasury, Office of Tax Policy (2002), *Corporate Inversion Transactions: Tax Policy Implications*, Washington, DC (May).

U.S. Department of the Treasury (2006), *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, Washington, DC.