Thanks. I want to start by saying that I feel genuinely honored to be here today. This conference is sponsored by two organizations that I admire greatly. The Tax Policy Center is respected widely for the high standard that it has set of intellectually rigorous, open-minded evaluation of tax policy. And the Internal Revenue Service has established a standard of integrity, impartiality, and competence in tax administration which is the envy of countries around the world. It's an understatement to say that the IRS doesn't always receive the public acclaim that it deserves – but it's important to acknowledge this country's good fortune in having the finest revenue administration in the world.

I'd like now to talk about a longstanding problem in tax policy and tax administration, which has played a large role in my professional life, and which has received greatly heightened political attention in recent years. This is the problem of the diversion of substantial amounts of income, by multinational taxpayers around the world, to affiliates incorporated in low- and zero-tax jurisdictions, where the affiliates often perform few if any observable, active business functions. This is, of course, the problem which the OECD has recently given the label "Base Erosion and Profit Shifting," or "BEPS," and which we read about almost daily in the news.

Let's start by looking at some history. To begin to understand the BEPS issue, it's necessary to look back more than fifty years, to the events that gave rise in the United States to the Revenue Act of 1962. In the years following World War II, this country had developed a burgeoning new technological capacity, including, notably, a new generation of "wonder drugs" which were of enormous commercial value around the world. Quickly, tax advisers to the pharmaceuticals industry developed the technique of establishing what came to be called "base companies" in countries which were willing to afford low or zero income tax rates to inbound business taxpayers – in those early postwar years, often Switzerland or some Caribbean

jurisdictions, including Puerto Rico. The U.S. parent companies would transfer cash to the base companies, which would then use that cash to obtain, usually from the U.S. parent company, rights to use valuable patents for pharmaceuticals and other products. Given the high value of the products they manufactured and sold using those rights, the low- or zero-tax subsidiaries would typically earn large profits, even after paying back royalties to the U.S. parent for the use of the intellectual property which the base company was using. The U.S. Treasury was troubled by the fact that the low- or zero-tax base companies, which generally appeared to be engaged in relatively little business activity of their own, appeared to be earning large amounts of income from intangible property that had been developed in the United States.

In attempting to address the problem of base companies, the Kennedy Administration and Congress had two basic options. First, they could have enacted, for the United States, a formulary system for dividing income among countries, like the system which the U.S. states and the Canadian provinces have used for many years. Under a formulary system, income is apportioned to affiliates of a taxpayer, in different jurisdictions, in proportion to the observable business activity that the different affiliates appear to conduct. For example, income might be apportioned among the affiliates based on some combination of the different affiliates' relative sales volumes, and relative levels of payroll expenditures. A formulary system of income apportionment would have addressed the problem of base companies by limiting their incomes only to amounts that were proportional to business activities the base companies actually conducted. This would have dramatically reduced the incomes of the base companies.

During the deliberations that led up to the Revenue Act of 1962, the House of Representatives in fact passed a bill that would have introduced formulary apportionment at the

federal level. The House proposal was not very well-developed technically, however, and it does not appear to have attracted much enthusiasm.

The other potential approach to base companies, which the Senate and ultimately the Congress adopted in the 1962 Act, was to seek to enact what are now known around the world as controlled foreign corporation, or CFC, rules. CFC rules generally provide that the incomes of those subsidiaries of a multinational group which are located in zero- and low-tax countries, and which appear to be earning income that is not attributable to the subsidiaries' active business activities, will be treated as having been earned by the parent company and therefore taxed in the parent's home country.

Congress apparently expected that the CFC it was enacting in 1962 would bring within the U.S. tax net a large amount of the income that then was being earned by base companies. For example, income earned by base companies in the form of royalties, or in the form of markups on products purchased by base companies from affiliates and resold at a profit, would have been caught within the net of the new CFC rules. The practice of income shifting to relatively passive base companies, it apparently was thought, would largely be largely curtailed.

But in the decades following enactment of the CFC rules, the rules proved surprisingly porous, for two main reasons. First, taxpayers found ways of circumventing the rules of subpart F through "contract manufacturing." Under a contract manufacturing structure, a base company doesn't conduct manufacturing operations itself, but instead pays other companies around the world to manufacture products for the base company, which the base company sells at a profit, typically without taking physical possession of the product that is sold. The base company remains passive, in that it doesn't conduct any manufacturing activities itself. However, the base company claims, for tax purposes, that the manufacturing activities for which it pays should be

attributed to the base company itself, so that it should be treated as if it were performing active business functions and its income exempted from taxation in the United States under subpart F.

The legal validity of the contract manufacturing argument has never fully been adjudicated, but companies used the contract manufacturing argument with great frequency and, in practice, contract manufacturing eventually nullified the 1962 CFC rules, at least as they apply to many companies.

And whatever was left of subpart F, after the contract manufacturing technique came into widespread use, was eliminated in 1996 when Treasury and the IRS issued the "check-the-box" regulations. The subpart F rules operate, in many instances, by classifying as subpart F income and taxing in the United States various items of passive income, such as royalties and interest, which are *received by* controlled foreign corporations. Now, the check-the-box regulations generally allow taxpayers to decide whether particular foreign entities, under their direct or indirect control, are to be treated for U.S. tax purposes as corporations, or instead are to be treated as unincorporated entities which are disregarded for tax purposes. Under the check-the-box rules, U.S. multinational groups are allowed to set up networks of international companies under which their affiliates in low- or zero-tax countries are treated for U.S. tax purposes as full-fledged corporations, but the subsidiaries of the low- or zero-tax affiliates, which operate in high-tax countries, are disregarded for U.S. tax purposes. This allows the affiliates in high-tax countries to pass along payments such as royalties and interest, to the low- and zero-tax CFCs that own them, without those payments being treated as having actually been received by the parent CFCs, so that the payments do not give rise to subpart F income. This result arguably rests on a hyper-technical reading of the check-the-box regulations and has attracted a lot of criticism. This reading of the check the box regulations, however, has long been accepted as

valid, and it essentially has nullified whatever remained of subpart F after contract manufacturing techniques became widespread.

I'm quite confident that in promulgating the check-the-box rules, the IRS and Treasury did not intend to repeal the rules of subpart F. Instead, I think they intended only to simplify the rules governing the classification of entities under the U.S. corporate income tax, which had proven difficult to administer for decades. When the Treasury realized that the check-the-box rules could be interpreted as nullifying rules under subpart F, Treasury tried to issue corrections which would change this result. But once it was widely realized that the check-the-box rules had conferred on U.S. multinationals effective exemption from subpart F, it became politically impossible for Treasury to take this large benefit back. Therefore, the check-the-box rules remain in effect today, and the subpart F rules today have little if any effect on base erosion structures.

With the effective demise of subpart F, the IRS has been left with two primary means of trying to challenge profit shifting by U.S. multinationals. First, the IRS can try to challenge the validity of base-erosion structures under the "economic substance," or "substance over form," or "business purpose" doctrine. Under this doctrine, the IRS can, in theory, disregard transactions, or legal entities, that do not serve a significant business purpose for the taxpayer other than the avoidance of U.S. taxes. Over the years, the IRS has successfully used this doctrine to disallow tax benefits from varying kinds of tax shelters, where courts have found the alleged investment plans of taxpayers to have been largely if not wholly fictitious, and where investments were made with the intention of generating losses, not income.

But the IRS has not seriously sought to apply the economic substance doctrine to the typical international profit-shifting structure; and if the IRS tries to do so, I doubt that the attempt

will be successful. It's true that typically, the low- and zero-tax affiliates involved in income-shifting structures perform few if any business activities, and it's also true that these companies facilitate the avoidance of large amounts of federal income tax. But it also is true that these foreign companies have unquestioned corporate reality – they conform to all the legal formalities required of corporations -- and the financial transactions in which they engage are parts of bona fide multinational business operations, which are involved with the manufacture of real products, or the provision of real services. Although some might differ with my views, I personally don't believe that in light of existing precedent, the Service is likely to prevail, in cases involving the income-shifting structures typically used today, by relying on the economic substance doctrine.

The other primary avenue for the IRS in cases involving profit shifting is to rely on the transfer pricing regulations under Section 482 of the Code, which were discussed this morning. A Section 482 challenge to a profit-shifting structure is based on the fact that usually, the U.S. parent company makes some kind of intangible asset available to the low- or zero-tax affiliate. This asset may consist of, say, a pharmaceutical patent or a software copyright at some stage of development; or it might consist of an asset that isn't formally legally protected like a patent, such as technical know-how, or maybe a business plan. A transfer pricing challenge in such a situation generally consists of a claim by the IRS that the low- or zero-tax subsidiary hasn't paid arm's-length compensation to the U.S. parent for the use of the intangible.

The IRS has been mounting transfer pricing challenges of this kind intensively in recent decades, but these challenges have almost always been unsuccessful, sometimes dramatically so. The reason is that it has proved enormously difficult for examiners to estimate the fair market value of unique intangible property to the satisfaction of a court. The process of valuation is factually intensive; it involves reliance on long-term financial projections, which are inherently

unreliable; and valuations also involve good deal of subjective judgment on the part of the government's economists.

It's true that formally, the law places the burden of proof on the taxpayer in a transfer pricing controversy. But as a practical matter it's the IRS which must move first, by asserting a value for an intangible asset that is different from the value reported by the taxpayer. The IRS's assertions about the value of intangible assets typically appear, to judges, to be far too speculative to support substantial claims against taxpayers. Indeed, it has not been uncommon over the years for courts not only to reject IRS assertions about the value of transferred intangibles, but to do so with thinly veiled impatience concerning the speculative nature of the IRS's claims. A good example can be found in the *Veritas Software* case, which the Tax Court decided a few years ago. Now, I don't see this kind of judicial reaction as the fault of the IRS and its attorneys and economists; instead, I think that the kind of judicial skepticism we've seen is basically inevitable, given the vagueness of the principles on which the IRS is required to rely when making assertions in transfer pricing cases.

The bottom line is that the two tools remaining to the IRS in attempting to control base erosion – the substance-over-form family of doctrines, and transfer pricing rules – have not proven effective. If Congress desires the IRS to be effective in reducing current levels of income shifting, Congress will need to legislate additional tools for the IRS to use.

Now, in a moment, I'd like to talk about the kinds of measures which Congress might consider. Before doing that, though, it may be useful to reflect on why high levels of profit shifting seem to have been tolerated, politically, in the United States for the more than fifty years which have elapsed since the Revenue Act of 1962. In particular, why hasn't Congress intervened to plug the holes that have become apparent in the CFC rules of subpart F?

The explanation for this forbearance by Congress can be found in the perceived problem of maintaining the competitiveness of U.S. multinationals. Over the years, as a result of the collapse of the subpart F rules and the ineffectiveness of alternative means of controlling income-shifting, many U.S. multinationals have succeeded in reducing their effective rates of tax on income from foreign operations to very low levels, sometimes approaching zero. Companies argue that over the years, other countries have afforded similar routes of avoiding income on foreign income to *their* multinationals, so that reinvigorating subpart F, or otherwise curtailing income-shifting opportunities, would place U.S.-based multinationals at an unacceptable competitive disadvantage.

There is a great deal of controversy among policymakers and commentators regarding the question whether constraining income-shifting opportunities would in fact place U.S.-based multinationals at a disadvantage-- but there is no question that many policymakers believe there would be an undue risk of such a situation arising And even if concerns about tax competition cannot be supported persuasively by empirical evidence – and I'm not in a position to offer conclusions one way or the other on this point – many U.S. multinationals have, through profit shifting, achieved effective rates which are so low, in absolute terms, that even in the absence of competitive concerns, eliminating opportunities for profit shifting might be seen as unwisely risking a serious economic shock. In short, Congress has acquiesced in base erosion over the decades because U.S.-owned companies appear to have become economically dependent upon it.

Income shifting also has persisted because, for most of the last fifty years, profit shifting has not been very apparent to the voting public. The tax reductions made available to companies by base erosion are visible, as a practical matter, only to those with especially detailed familiarity with the tax system. Relatively few voters in the United States have had detailed awareness or

understanding of the base erosion structures used by U.S. multinationals. Sometimes the issue has briefly risen to political prominence, as it did during the presidential campaign of 1992 – Bill Clinton's first campaign – but by and large the topic of income shifting has been one for the professional, not the general, press.

Recently, however, the political environment surrounding profit shifting and base erosion has changed. The change began about four years ago, when several nongovernmental organizations, including notably the UK charity Christian Aid and the UK affiliate of the South Africa-based charity, ActionAid, published reports arguing that opportunities for base erosion raise large incentives for multinational companies to shift income from the tax bases of the poorest developing countries. For example, it was argued, multinationals were shifting income from developing countries through interest being paid on intragroup loan arrangements and through royalties paid for the use of trademarks. In these and other ways, it was argued, profit-shifting techniques were contributing fairly directly to human suffering in some very economically strapped developing countries.

Leading media outlets in countries around the world noticed the arguments made by the NGOs. Soon, media stories pointed not only to the revenue losses of developing countries, but also of comparatively wealthy countries which were suffering perceived crises in government revenues in the years following the global financial crisis. Public feeling became particularly intense in the United Kingdom, following news stories and legislative inquiries involving Starbucks, Amazon, and Google, all companies with which the general public was well acquainted. Not only in the United Kingdom but elsewhere in the world, including the United States, a strong impression was created that multinational companies today enjoy opportunities for tax avoidance that are not available to ordinary taxpayers.

The long period of dormancy of income shifting as a popular political issue was now decidedly ended. The G-20 group of countries and the OECD stated clearly, last year, that base erosion and profit shifting constitute an unacceptable defect in the international tax system, and the OECD is engaged in an intensive project to recommend remedies. Many national governments around the world, including that of the United States, have indicated that they plan to entertain legislation to address base erosion. The issue also was raised in the G-8 summit this week in Northern Ireland. It seems likely that in the reasonably near future there will be legislation to address base erosion, in the United States and other countries around the world.

What might such legislation look like, especially here in the United States?

I think first, as a general matter, that despite the arguments that might be made for eliminating base erosion opportunities entirely, legislation will need as a practical matter to curtail base erosion only partially, at least initially. Elimination of base erosion opportunities entirely, on a cold-turkey basis, is likely to be seen as unduly risky, both economically and politically. I simply don't think it's going to happen, at least not in the short term.

And I think that the infeasibility of the wholesale elimination of opportunities for base erosion rules out, at least for right now, an attempt to address base erosion and profit shifting through the adoption of a formulary system of income apportionment. Now, it is my firm belief that over the decades, political discussion of formulary apportionment has exaggerated its administrative and other difficulties, and has understated its potential benefits with respect to both the fairness and simplification of the tax system. In the long and maybe even intermediate term, I think that formulary apportionment will turn out to be a viable and helpful addition to the international tax system. But the main problem with formulary apportionment, as a short-term remedy for base erosion, is that it would be too effective. By making it impossible to shift large

amounts of income to entities that perform little if any real business activity, formulary apportionment would effectively end base erosion. I don't believe such effective elimination of base erosion opportunities is politically feasible, at least not right now.

What I do think might be feasible is another approach, which would borrow from a number of proposals that have been made by others over the past few years. In particular, a viable approach might be to tighten CFC rules so as to tax under subpart F the income of low- and zero-income CFCs that earn anomalously high returns on their costs – but to tax this income not at the full statutory corporate rate of thirty-five percent, but at a lower rate such as fifteen or twenty percent. This approach would raise federal revenues; and it would reduce incentives for U.S.-based multinationals to shift income from developing countries, and other countries around the world, where they conduct business. In addition, by taking this approach, Congress would be able to demonstrate to voters that Congress is taking substantial steps to redress what is now seen as a troubling anomaly in our tax system. In short, while not rising to the level of a complete remedy, the partial curtailment of base erosion opportunities through a tightening of current CFC rules could result in substantial improvements to the situation that we face today.

Also, this approach, if successful, might end up serving as a preliminary step toward more comprehensive reforms that could result in a much simpler and fairer international tax system. Over time, the general statutory corporate rate in the United States might be lowered, as many have recommended, so that the regular rate would approximate the reduced rate that would be charged under the suggested revised CFC regime. Once the two rates are the same, or nearly so, U.S.-based multinational companies would no longer enjoy substantial tax benefits from their base erosion structures. The political and economic barriers which now stand in the way of truly comprehensive international tax reforms would, finally, be removed.

With base erosion a thing of the past, there might then no longer be prohibitive political or economic impediments to fundamental legal changes, perhaps including formulary apportionment, which would eliminate the many barriers to enforcement now present under the transfer pricing rules, as well as territorial taxation , which I have not discussed today but which could have many administrative advantages, provided that opportunities for profit shifting have first been eliminated. Therefore, the taking of the first step, today, of strengthened CFC rules could lead over the years to a fundamentally reformed international tax system for the United States – an appealing prospect to contemplate.

But now, before ending this talk, I need to make one more, very important point. The current concern with profit shifting and base erosion began when Christian Aid, ActionAid, and the other nonprofit organizations raised the alarm about the effects of income-shifting practices on the well-being of people in developing countries. Base erosion today does indeed cause serious damage in developing countries -- and the CFC-based remedy which I see the United States, and possibly other industrialized countries, pursuing will not be enough to eliminate this damage. Even after adopting partial fixes to base erosion through CFC rules and perhaps other, similar measures, the industrialized countries will leave still on the table, for multinationals, substantial incentives to shift income from the tax bases of developing countries.

Conceivably, the tax administrations of developing countries could try to combat this base erosion through stepped-up transfer pricing enforcement. I fear, though, that increased transfer pricing enforcement will be of little if any real benefit, at least in the near term. Even to attempt transfer pricing enforcement requires specialized personnel and accumulated expertise which most developing countries do not have; and experience in the United States and elsewhere has shown that even the most sophisticated transfer pricing enforcement efforts might have little

if any success against today's base erosion practices. Indeed, it is far from clear that, as a legal matter, the techniques that are commonly used to shift income from developing countries, including intragroup lending and royalty arrangements, violate existing transfer pricing laws. In short, developing countries should not attempt to rely on transfer pricing enforcement as their primary protection against base erosion.

Instead, developing countries would be well advised to adopt statutes which are, in effect, the mirror image of CFC rules. Developing countries should enact statutes under which deductions will be allowed, for payments made by a taxpayer to a related person, only if the taxpayer can certify that the payment is not destined, directly or indirectly, to a recipient in a low- or zero-tax country, where the recipient has an abnormally high return on locally incurred expenses. Such a statute, if carefully drafted and enforced, would be administrable, and it could provide developing countries with meaningful protections against base erosion.

Designing and implementing a workable deduction-limitation statute for developing countries will raise significant technical and political challenges. I've written a bit about this topic in the past; and it is clear that a good deal of expert work will need to be done in order to design and enact effective protective statutes for developing countries. I believe that part of the response to base erosion and profit shifting, on the part of industrialized countries such as the United States, should be concerted efforts, through international expert organizations including the OECD, the IMF, the World Bank, and ideally a strengthened United Nations tax expert group, to assist developing countries to design, enact, and implement legislation to prevent deductions related to base-erosion practices. Unless steps like this are taken, I think it likely that the most costly effects of base erosion and profit shifting, in terms of human welfare, will remain largely unaddressed.

So to summarize: In the past several years, public interest around the world has been focused to an unprecedented extent on the shifting of income from countries where business is conducted, to largely inactive subsidiaries of multinational companies based in low- or zero-tax countries. The public interest was first sparked by reports of the damage caused by income shifting from the tax bases of the most economically challenged developing countries, but attention also has been focused on income shifting even from the wealthiest industrialized countries.

The jury is still out, but it appears that the wealthier countries, based in part on work being conducted by the OECD, are on their way toward reducing the attractiveness of base erosion practices to multinational companies, by partially removing the benefits from those practices, probably through strengthened CFC rules. Measures of these kinds will be beneficial and should be welcomed, but the efforts of the wealthier countries should not stop there. Instead, the wealthier countries of the world should remember the special and pressing needs of developing countries with which the current public re-examination of base erosion issues began. The wealthier countries, working through the expert international organizations of which they are members, should devote substantial efforts to assisting developing countries in designing, enacting, and implementing the kinds of legislation that could, by limiting deductions in appropriate circumstances, protect developing countries from losses of public revenues which could materially impede those countries' economic and social development.

Thanks.