



THE NATIONAL FOREIGN TRADE COUNCIL

SUBMISSION OF WRITTEN COMMENTS FOR THE HEARING RECORD

**U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS**

HEARING ON TRANSFER PRICING ISSUES

AUGUST 5, 2010

Mr. Chairman, Ranking Member Camp and Members of the Committee:

The National Foreign Trade Council (the “NFTC”) is pleased to submit written comments for the record in connection with the July 22, 2010 hearing of the Committee on Ways and Means (the “Committee”) on the important topic of transfer pricing. The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and we seek to foster an environment in which worldwide American companies can be dynamic and effective competitors in the international business arena.

Based on Chairman Levin’s opening statement, we understand that the purpose of the hearing was to provide the Members of the Committee with a better understanding of the mechanics of transfer pricing and the significance of transfer pricing to the U.S. government and to worldwide businesses, rather than to focus on the advisability of any specific proposals. Accordingly, our comments provide some background on the transfer pricing rules, the importance of principles-based transfer pricing rules to worldwide American companies, and concerns regarding the direction of some of the testimony provided to the Committee at the hearing.

Transfer Pricing - In General

“Transfer pricing” refers to the prices charged in cross-border transactions or arrangements between members of a controlled group of companies, or related parties. Transfer pricing rules are designed to allocate profits and losses appropriately among related parties. Transfer pricing rules thus serve to divide rights to tax the income earned by worldwide businesses among the countries in which they operate. All Organisation of Economic Co-operation and Development (“OECD”) member countries, and many non-OECD member countries, have transfer pricing rules. The U.S. rules are based on section 482 of the Internal Revenue Code, the detailed regulations promulgated thereunder, and U.S. income tax treaties.

Workable and consistent transfer pricing rules are very important to worldwide businesses. Absent such rules, income earned by such businesses could be subject to competing taxing claims by the many countries in which they operate, leading to irresolvable disputes and double taxation of the same income. This would be inconsistent with longstanding U.S. and international tax norms, would exacerbate tax barriers to cross-border investment, and would reduce the competitiveness of the U.S. economy and of worldwide American companies.

The arm's length standard is the international standard by which proper transfer pricing is measured. This standard has long been incorporated in U.S. domestic tax law and virtually all U.S. tax treaties. It has been adopted by the OECD and virtually every major industrial nation. It is important to note that the United States has played a leadership role over many decades in advocating the adoption and development of the arm's length standard as the international standard.

Under the arm's length standard, prices charged in related party transactions should be consistent with prices that would have been charged in unrelated party transactions under similar circumstances. The purpose of the standard is to place related parties on "tax parity" with unrelated parties. The standard is intended to ensure that results of related party transactions are benchmarked against the results of actual transactions between unrelated parties. Unlike the arm's length standard, apportionment of profits based on a formula does not reflect the underlying economics of a business.

The Role Of Transfer Pricing In The International Tax Framework

The transfer pricing rules operate in a broader international tax framework. The United States maintains a system of worldwide taxation, taxing U.S. persons (including corporations) on their worldwide income. Most active business income earned by foreign subsidiaries of worldwide American companies is not subject to U.S. tax until it is repatriated. A foreign tax credit is provided for foreign taxes paid directly or indirectly by U.S. persons on foreign income, subject to various limitations. The transfer pricing rules provide an input into this system by determining the allocation of income between worldwide American companies and their foreign subsidiaries.

The U.S. corporate tax system is at odds with international norms in two respects. First, most other countries, including the United Kingdom, Japan, Germany, and France, have a "territorial" system of taxation that generally does not tax the active foreign business income of resident companies. The international trend in favor of territorial systems is pronounced; in 2009, the United Kingdom and Japan moved from worldwide systems to territorial systems to facilitate the repatriation of earnings into their home economies and to promote the competitiveness of their global companies. Second, the U.S. corporate tax rate is among the highest in the world, and is almost 15 percentage points higher than the average corporate tax rate among OECD member countries.

Within this context, the Committee should be skeptical of assertions that effective tax rates reported by some U.S. corporations demonstrate the existence of transfer pricing abuses. Recent research confirms that the effective tax rate on worldwide American companies is among the highest in the world. It is not surprising, then, that some worldwide American companies with significant international activities would report effective tax rates well below the statutory U.S. corporate tax rate. The applicable tax rate associated with foreign active business income is the local rate of tax, unless there is a plan to repatriate the earnings back to the United States. Because the corporate income tax rates of virtually all countries are lower than the U.S. rate, it would be expected that worldwide American companies with significant and growing international activities would report effective tax rates lower than the statutory U.S. rate. Thus, the effective tax rates of such American companies are the direct result of an increase in foreign earnings and the reinvestment of such earnings to fund additional international expansion in the global economy, rather than transfer pricing abuses as suggested in some of the testimony. Indeed, the U.S. tax on repatriation of foreign active business earnings, which is at odds with international norms, inadvertently provides a disincentive to worldwide American companies to reinvest foreign earnings in the United States rather than make investments in U.S. jobs and activities.

Further, some of the testimony conflates transfer pricing as between U.S. and foreign affiliates with foreign-to-foreign transfer pricing practices, treating each as a potential threat to the U.S. tax base and the U.S. economy. The NFTC recognizes that the U.S. transfer pricing rules serve the important governmental objective of protecting the U.S. tax base by ensuring that transactions between related foreign and domestic entities are priced appropriately. It is less clear whether the Committee should be concerned with the pricing of foreign-to-foreign transactions that do not have a direct effect on the U.S. tax base. Consistent with applicable legal obligations, worldwide American companies would be expected to minimize their foreign tax liabilities on their international activities, thereby maintaining a competitive balance with foreign competitors. It is not clear how changing U.S. law to force worldwide American companies to pay more foreign tax on their international activities would further tax policy objectives or promote the U.S. economy.

The Arm's Length Standard Is A Bedrock Principle That Should Not Be Eroded

As noted above, the arm's length standard is the international standard in the transfer pricing area. It has attained that status in part through the leadership of the United States over many decades. The arm's length standard is a bedrock principle underlying the international tax framework.

A single consistent, workable international standard is critical in the transfer pricing area. If countries adopted different standards, double taxation would result, and there would be no principled way to resolve competing taxation claims over the same income. The arm's length standard provides a principled standard for countries to follow in applying their own transfer pricing rules, and provides a common standard for the resolution of competing claims among countries. In this regard, the NFTC agrees with the testimony in support of the arm's length standard by Stephen E. Shay, Treasury Department Deputy Assistant Secretary (International Tax Affairs), on behalf of the Administration.

The Committee should be extremely skeptical of alternative standards. These alternatives are all based to a greater or lesser extent on the application of formulas to allocate income, and are collectively referred to as methods of "formulary apportionment." Any formulary method is arbitrary and distortive, and would result in the disparate tax treatment of cross-border related-party transactions. The arm's length standard, on the other hand, is grounded in fundamental economic principles and therefore reflects a principled and evenhanded approach to allocation of revenue among countries. More importantly, regardless of the merits of a formulary approach, it is difficult to imagine countries with varying economic interests agreeing to a consistent formula for allocating income among related persons. The temptation for each country to adopt a formula to maximize tax revenues would be irresistible, and double taxation would result.

The Committee also should be skeptical of proposals that pay lip service to the arm's length standard, but undermine its central role in the transfer pricing area. In particular, the Administration's proposal to impose current U.S. tax on so-called "excess returns" earned by foreign subsidiaries of worldwide American companies would call into question the United States' commitment to the arm's length standard and would lead to double taxation. Although the details of the proposal have not been fully articulated, it would appear to apply a simple formula to determine whether profits of a foreign subsidiary are "excessive" and therefore should be treated as earned by the U.S. parent corporation instead. There would be no consideration of whether the foreign subsidiary was entitled to such profits under the arm's length standard based on its risks, functions or activities. Indeed, the proposal would apply even where the transfer pricing between the foreign subsidiary and its U.S. parent corporation were reviewed by the Internal Revenue Service (the "IRS") and any other relevant tax authority and determined to be consistent with the arm's length standard. It is critically important to examine the implications of such a proposal as any perception that the United States is retreating from the arm's length standard would encourage other countries to do the same and lead to double taxation.

Changes To The Transfer Pricing Rules Should Not Be Considered In A Vacuum

The NFTC recognizes that some policymakers view the current transfer pricing rules and their enforcement by the IRS as inadequate. Any changes to such rules, however, should be considered in the context of the international consensus supporting the arm's length standard as well as the current U.S. international tax rules.

Any adjustments to the well-established and long standing transfer pricing rules should be considered in the context of the need for taxpayers and governments to rely on a network of well settled and predictable rules that reflect the functions and risks undertaken by businesses in the global marketplace. The principle purpose of the transfer pricing rules is to provide a fair and equitable allocation of income tax revenues among countries and to avoid double taxation. Over the years, consensus has been developed in the network of tax treaties (including U.S. tax treaties) that reflect the arm's length standard consistent with the U.S. and OECD Model Tax Treaties, as well as the OECD Transfer Pricing Guidelines. The OECD Transfer Pricing Guidelines provide definitive guidance to countries on the application of the arm's length standard, and can be modified by consensus of OECD member countries where necessary to reflect developments. The OECD thus provides a mechanism for considering changes to the application of the arm's length standard. Indeed, the guidelines were recently updated to reflect certain developments. This mechanism is far preferable to unilateral actions. At a minimum, consideration of any contemplated changes to the U.S. transfer pricing rules should be made with due regard to existing U.S. treaty obligations.

Significant changes to the transfer pricing rules should be considered only in the context of a reexamination of the U.S. international tax system. As noted above, the U.S. rules are at odds with international norms in two respects. First, the U.S. taxes active foreign business income upon repatriation under the current worldwide system. Second, with Japan's recent tax reduction announcement, the U.S. corporate tax rate will soon be the highest statutory income tax rate in the industrialized world. These aspects of the U.S. rules interact with the transfer pricing rules in a variety of ways. For example, the relatively high U.S. tax rate creates significant pressure on the transfer pricing rules that would be reduced if the U.S. rate were in line with international norms. A reduction in the U.S. corporate tax rate would ease the pressure on the transfer pricing rules and make them more administrable, in addition to making the U.S. economy more attractive and competitive. In this regard, transfer pricing issues may be a symptom of broader issues with the U.S. international tax rules, and therefore should not be addressed in isolation.

Implications Of Proposals On Research Intensive Industries Must Be Considered

Much of the testimony before the committee, as well as the Administration's excess returns proposal, focuses on industries that rely on U.S. innovation. Companies in such industries, including the pharmaceutical and high-tech industries, undertake significant research and development ("R&D") activities in the hopes of developing innovative products. These activities generate desirable, high-paying jobs for the U.S. economy, and the United States remains a leader in high-end R&D activities notwithstanding significant inroads made by research centers throughout the world. Technological advances achieved through U.S. R&D are responsible for significant increases in economic growth and worker productivity, which inure to the benefit of all participants in the U.S. economy.

Some of the testimony before the committee, as well as the Administration's excess returns proposal, appears premised on the notion that the income from any intangible property developed by U.S. R&D activities must be taxed in the United States regardless of the economic or contractual arrangements under which the U.S. R&D is conducted. This is not consistent with the arm's length standard or with demonstrated behavior by third parties. Under the arm's length standard, the person or persons that bear the risks of the R&D activity are entitled to the income from successful R&D. It is sensible for corporations in these industries to establish transfer pricing policies that reflect an allocation of R&D risk to regional centers around the world, rather than centralize such risk in any one particular place. This reflects the fact that the costs of inevitable failures and false starts are borne by the global revenue base of large worldwide companies, not by the location of R&D activities. Proposals that would contravene the arm's length standard in this context could have a detrimental impact on R&D intensive industries and on the U.S. economy. Taxing the results of U.S. R&D at rates in excess of corporate tax rates around the world will encourage future R&D centers to be located outside of the United States, to the detriment of the U.S. economy and U.S. workers.

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Thank you for the opportunity to submit these written comments for the record. The NFTC looks forward to working with you, your staffs and all Members of the Committee to ensure that the U.S. transfer pricing rules facilitate and enhance the competitiveness of the U.S. economy and of worldwide American companies.