

**Statement of Business Roundtable
for the Record of
the House Committee on Ways and Means
Hearing on Transfer Pricing Issues
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American companies with operations both at home and abroad are responsible for 63 million U.S. jobs. These companies directly employ 22 million American workers and they create an additional 41 million American jobs through their supply chain and the spending by their employees and their suppliers. The ability of American companies to be competitive in both domestic and foreign markets is essential to the creation of well-paying American jobs and rising living standards.

Business Roundtable strongly supports tax policies that increase the opportunity of American companies and their workers to be competitive in markets at home and abroad. Business Roundtable opposes raising additional taxes on foreign business activity above the local level of tax, thereby making goods and services of American companies less competitive in those markets.

Business Roundtable is an association of chief executive officers of leading U.S. companies with nearly \$6 trillion in annual revenues and more than 12 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and more than 60 percent of all corporate income taxes paid to the federal government. Annually, they pay \$167 billion in dividends to shareholders and the economy.

Business Roundtable urges the Committee to critically assess the effects of any tax changes it considers on the ability of American companies and their workers to compete globally. Business Roundtable believes that tax changes, if considered with an objective of increasing the competitiveness of American companies, can be an important factor in boosting U.S. employment in the near term and putting the country on a strong path for future economic growth.

In a recent study, researchers at McKinsey & Company point out that while U.S.-headquartered multinational companies account for less than 1% of all U.S. companies, they:

- employ 19% of the U.S. private sector workforce;
- pay 25% of all private sector wages; and
- account for 74% of America's private sector R&D spending.

McKinsey states that: "Given the importance of multinationals to the U.S. economy, it is critical that they compete -- both at home and abroad -- on at least an even basis against companies domiciled in other countries."

Changes in the area of international taxation in particular have the potential to significantly affect the ability of American companies to compete on a level playing field with their foreign-headquartered competitors.

U.S.-headquartered companies already operate at a significant tax disadvantage relative to their competitors. U.S. companies face the second highest corporate tax rate in the OECD. The combined federal and state statutory tax rate is 39.2%, more than 50 percent higher than the average tax rate in the rest of the OECD of 25.5%.

The United States is also one of the few OECD countries that taxes companies on their foreign earnings when brought home. Of the other 30 OECD countries, only five others (Chile, Ireland, Korea, Mexico, and Poland) tax active foreign earnings, and these countries have a much lower corporate tax rate than the United States (an average rate of 20.5%).

Other countries also provide greater incentives to undertake investments in R&D, to foster innovation and increase productivity. According to the OECD, the United States ranks 24th out of 38 OECD and advanced emerging economies in terms of the competitiveness of its R&D tax incentives.

These tax disadvantages relative to the tax systems of our trading partners reduce the ability to sell U.S. goods and services in foreign markets, reduce U.S. employment and exports, and reduce investment, innovation, and productivity growth -- all serving to diminish U.S. living standards.

As we look to the rest of the world, we see countries designing tax systems to attract businesses and capital investment and to improve the competitiveness of their companies and workers. In announcing corporate rate reductions and further tax reforms in the United Kingdom in June to improve the competitiveness of the UK tax system, the Chancellor of the Exchequer, George Osborne, stated: "We need to see growth not just in one corner of our country, nor in just one sector. For we live in a world where the competition for business is growing ever more intense. I want a sign to go up over the British economy that says 'Open for Business'." American companies and American workers also need a competitive tax system that shows the United States is open for business as well.

Transfer Pricing

U.S. tax law requires that taxpayers report income earned on transactions with related parties by setting appropriate internal prices for these transactions. Transfer pricing is simply the process by which these internal prices are determined. Under current law, transactions between a U.S. parent company and its foreign subsidiaries are required to use the same prices that the parent company and its foreign subsidiaries would use with unrelated companies -- also known as the "arm's-length" standard.

The United States has long championed the use of the arm's-length standard and it has been and it continues today as the foundation of U.S. and OECD transfer pricing guidelines.

Arm's-length transfer pricing is a mainstay of corporate income tax policy because it best reflects the underlying economics of business operations. It is also the recognized basis used to resolve double taxation issues in numerous U.S. and foreign tax treaties.

The international use of the arm's-length standard allows for agreement by countries with potentially conflicting interests to use a well-accepted, economically realistic principle for determining the source of income in cross-border transactions between related parties.

The transfer pricing system is regularly reviewed and rigorously enforced by the Internal Revenue Service through audits, advance pricing agreements, and the rule making process. Foreign governments also enforce and monitor transfer pricing to ensure that the foreign government taxes its proper portion of profits sourced to it.

While the system of transfer pricing is complex, there is general global consensus that the arm's-length standard should be adhered to throughout the world.

If the United States followed a different system for determining transfer prices -- for example, in an effort to increase the share of income in certain transactions to be sourced to the United States -- double taxation would result since income properly taxable by a foreign country under the arm's-length method would also be subject to U.S. income tax under this different system.

As a result, it is important for the United States to employ internationally consistent rules in determining transfer pricing. Further, because American companies compete with foreign-headquartered companies that operate both abroad and in the United States, the ability of American companies to operate on a level playing field requires that consistent rules apply to both U.S. and foreign companies.

Treasury's testimony in this hearing states that there is evidence of improper transfer pricing undertaken by U.S. taxpayers in its analysis. However, as is reported in the underlying Treasury analysis on which Treasury's testimony is based, the data analyzed cannot be used to determine whether non-arm's-length pricing has in fact occurred.¹ Such a determination requires transactional level data that has not been examined by Treasury in this analysis. In fact, no U.S. court would uphold a claim of non-arm's length pricing having occurred on the basis of the data presented by Treasury in its testimony.

As noted by the Joint Committee on Taxation report prepared for this hearing, the same business structures used by the U.S. companies it studied are available to, and employed by, the foreign-headquartered competitors of U.S. companies.² These substantive business organizations are an important part of rational and prudent business operations on a pre-tax basis. American companies and their U.S. workers would be placed at an even more severe competitive disadvantage if American companies were subject to different transfer pricing

¹ See, for example, limitations in the data that prevent their use in establishing a conclusion of non-arm's-length pricing reported in the Treasury Office of Tax Analysis working paper conducted by Michael McDonald (OTA Working Paper 2, July 2008, pages 8, 9, 19, 21, and 35).

² See Joint Committee on Taxation, JCX-37-10, July 22, 2010, p. 105.

rules than their foreign-headquartered competitors. Even without any further constriction of U.S. tax law, American multinationals on average pay a higher global effective tax rate than their foreign competitors.³ U.S. international tax rules should not inhibit an American company's choice of substantive organizational structure for its business.

It is also important to note that the United States economy directly benefits through proper tax planning and business structuring undertaken by American businesses that reduce their foreign tax liability. Reductions in the foreign tax liability of a U.S. company increase the overall profitability of the company, allowing it to increase its overall scale of operations, including its U.S. employment, U.S. investment, and earnings paid to largely U.S. shareholders.

The Administration's Proposal on "Excessive Returns"

The Administration's budget proposes to tax worldwide American companies on "excessive returns" of their foreign subsidiaries without deferral when an intangible asset has been transferred to a foreign subsidiary if there is evidence of "excessive income shifting" and the foreign subsidiary has a "low" effective tax rate.

While little detail is provided in the Treasury Department's explanation of the proposal, including the definition of "excessive returns," it appears the Administration proposal would apply to transfers of intangibles that comply with the arm's-length standard and the proposal would not change the internal transfer prices used in pricing these transactions. Instead, the proposal would repeal deferral for this income, resulting in current taxation of the same income both in the jurisdiction of the foreign subsidiary and in the United States.

The loss of deferral under the Administration proposal would create a competitive disadvantage for worldwide American companies expanding into foreign markets, exposing a significant portion of their foreign earnings to immediate U.S. taxation. Most OECD trading partners (25 of the other 30 OECD countries) exempt from home country tax the foreign income of their multinational companies, and the other five OECD countries defer from home country tax the foreign income of their companies. Thus, the United States would be the only country to tax its resident companies in this arbitrary fashion.

The proposal to tax currently the "excess" earnings from intangibles would discourage U.S.-headquartered companies from undertaking R&D in the United States and from making other U.S. investments and acquisitions giving rise to intangible assets, since income earned from the transfers of these assets would be subject to immediate U.S. taxation. The new tax would create an incentive for companies to move R&D activities offshore and have its foreign affiliates acquire intellectual property from third parties. There are many foreign jurisdictions with world class resources that aggressively pursue large R&D investments.

³ For example, effective tax rate analysis for 2006 shows U.S.-headquartered multinationals have the highest effective tax rate of companies in all jurisdictions except Japan (Kevin Markle and Douglas Shackelford, NBER Working Paper 15091, June 2009). Since this study was conducted, many countries have made further reductions in their statutory corporate tax rate, while the United Kingdom and Japan have adopted territorial systems.

The loss of R&D and acquired intellectual property to foreign locations would mean that the R&D jobs and the valuable intellectual property would no longer originate in the United States. The United States would sacrifice high-paying U.S. jobs and suffer slower economic growth.

The proposal would favor foreign-headquartered companies over U.S.-headquartered companies. Foreign-headquartered companies, for example, could exploit intangibles developed in the United States (and in other countries) in foreign locations without being subject to U.S. tax on their foreign profits.

This advantage to foreign companies might make U.S. companies acquisition targets as their intangible assets could be more profitably exploited in foreign locations by foreign-headquartered companies rather than remaining under the control of U.S.-headquartered companies and their foreign subsidiaries.

In summary, the Administration proposal would discourage creation of intangible assets in the United States and result in a loss of high-paying U.S. jobs. It would repeal deferral for worldwide American companies on a portion of their foreign earnings and place worldwide American companies at a competitive disadvantage relative to their foreign counterparts, resulting in a further loss of U.S. jobs and less growth for the U.S. economy.

As the rest of the world makes it easier for their companies to operate worldwide, this proposal would be a movement in the opposite direction, endangering U.S. jobs and making it more difficult for American companies to compete in overseas markets.

Conclusion

Business Roundtable believes that significant reform of the corporate tax system is needed to accelerate U.S. job creation, increase investment, and improve U.S. competitiveness. Business Roundtable looks forward to working with this Committee in our shared desire to achieve these important objectives. We must also ensure that measures considered by this Committee do not have the unintended effect of diminishing the ability of American companies to compete in U.S. and foreign markets, to the detriment of the tens of millions of American workers dependent on their success in world markets.