What’s Behind the Pressure for a Worldwide Tax Agreement?

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Profit Shifting: Two types

- Actual Relocation –A U.S. multinational physically moves activities from the United States to another country. For example, over the past several decades, many U.S. multinationals moved the manufacturing of their products from the United States to Asia. In doing this, they typically move activities and often related intangible property into foreign subsidiaries. When this happens, the portion of the multinational’s overall profits that is attributable to those activities and intangible property are earned by the foreign subsidiary instead of the U.S. parent.
- Mostly Paper Relocation–The U.S. multinational may need to perform some functions in the location of customers/users (e.g. marketing and sales, customer support, logistics, etc.), but the principal activities and assets that give value to the multinational’s business and are the main source of the multinational’s profits remain within the United States. Google, Facebook, and Apple have been accused of this sort of profit shifting, with the late Senator John McCain saying about Apple in 2013:

> “As the shadow of sequestration encroaches on hardworking American families, it is unacceptable that corporations like Apple are able to exploit tax loopholes to avoid paying billions in taxes. . . . It is completely outrageous that Apple has not only dodged full payment of U.S. taxes, but it has managed to evade paying taxes around the world through its convoluted and pernicious strategies. . . . It is past time for American corporations like Apple to reorganize their tax strategies, to pay what they should, and invest again in the American economy."

Elements of Both Types– As will be appreciated, sometimes things get fuzzy and there are elements of both types of profit shifting. Thus, a company like Apple previously manufactured most of its products within its own U.S. plants. When it moved physical production to Asia, though, it no longer operated its own plants. Rather, it arranged for contract manufactures (e.g. Foxconn) to perform the physical manufacturing. While this physical function was performed by Foxconn and others, many other production functions remained in California. For example, such production functions likely include management and day-to-day work to decide what to manufacture, what specifications to achieve, where to source components and negotiation with vendors and contract manufacturers, what

production timing and inventory levels should be, quality control, logistics, etc. Companies like Apple may have plenty of marketing, sales, and customers support people located outside the United States. However, in today's centralized management models, U.S.-based personnel will often not only determine, direct, and manage international sales strategies, but they will also be involved in day-to-day negotiations and sales efforts with major customers.

Have Multinationals Been Successful at Shifting Profits?

- Focusing on just 2017 and eleven tax havens, Deputy Assistant Secretary Kimberly Clausing (Treasury Department) estimated that profit shifting created an annual loss of profits from the U.S. tax base of between $213 billion and $265 billion. Considering that this profit shifting has been going on for well over two decades, the cumulative loss of profits from the U.S. tax base must be in the trillions with the actual tax loss being at least in the hundreds of billions. (Secretary Clausing made and released her estimates prior to her Treasury appointment.)
- Secretary Clausing also calculated that *roughly two-thirds of the real activities that earned shifted profits took place within the United States*.

Objectives of Profit Shifting – Avoid or minimize tax in:

- Countries where actual operations are performed; and
- The United States.

This has meant that many U.S. multinationals have set up structures in tax havens or other low-tax countries to hold their shifted profits.

How Did We Get Here?

- Our taxation system strongly encourages profit shifting (no U.S. tax on foreign profits until paid as dividends to U.S. shareholders up through 2017, and a 10.5% rate since 2018 instead of the domestic 21% rate)
- Separate entity principle (each group member treated as a separate legal person despite full common ownership—this allows multinationals to play games by creating subsidiaries anywhere and then crafting inter-company contracts that push profits into zero and other low-taxed subsidiaries…with 100% ownership, it doesn't economically matter in which subsidiary a group earns its profits…except for differences in taxation)
- Despite intra-group transactions that are primarily tax-motivated, tax authorities and courts worldwide accept and respect them
- The "arms-length standard" (generally third-party standard applied to price intra-group transactions)
- U.S. "check-the-box" rules that significantly aid the creation of profit-shifting hybrid structures (eases the process of arbitraging different tax rules that apply in the United States and other countries)

- Accounting results and management greed (management stock options and other equity-based compensation encourage multinational managements to push the envelope on taxation so as to achieve higher earnings per share, higher stock prices, and thus higher personal compensation)

There's more to this story.[1] Suffice it to say that as of today, the motivation to continue profit-shifting structures will continue.

But U.S. CEOs Say They Need Low Taxes to Be Competitive on World Markets

- Whether this is true is debatable[2]
- More importantly, this ignores the more important tax policy consideration of fairness for pure domestic businesses that compete with multinationals

Where's the fairness in domestic corporations paying 21% and multinationals paying 10.5% on the earnings in their foreign subsidiaries?

Politicians and the press generally buy this claim by multinational CEOs. For example, a July 9, 2021, Wall Street Journal editorial stated about the proposed G20/OECD worldwide minimum tax:

> "This is still a bad deal for the U.S. Congress will need to pay close attention to what is -- and isn't -- in it before making American firms less competitive around the world."

If this domestic competitiveness issue is important to you, and especially if you have a domestic business that competes with one or more multinationals, you might want to let your Senators and Representatives know that you'd like this fixed. This would mean applying the same corporate tax rate to domestic profits and to foreign income recognized under the GILTI regime.

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[1] If you'd like to read more, see Kadet, "BEPS Primer: Past, Present, And Future", *Tax Notes Federal* (in two parts, July 6 and 13, 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3669899 and https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3674040.

[2] See Kadet, "U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling", 139 *Tax Notes* 295 (April 15, 2013), at 298, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2275488.