STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIATIONS
ON
OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE

September 20, 2012

America stands on the edge of a fiscal cliff. This challenge lends new urgency to a topic this subcommittee has long investigated: how U.S. citizens and corporations have used loopholes and gimmicks to avoid paying taxes. This subcommittee has demonstrated in hearings and comprehensive reports how various schemes have helped shift income to offshore tax havens and avoid U.S. taxes. The resulting loss of revenue is one significant cause of the budget deficit, and adds to the tax burden that ordinary Americans bear.
U.S. multinational corporations benefit from the security and stability of the U.S. economy, the productivity and expertise of U.S. workers and the strength of U.S. infrastructure to develop enormously profitable products here in the United States. But, too often, too many of these corporations use complex structures, dubious transactions and legal fictions to shift the profits from those products overseas, avoiding the taxes that help support our security, stability and productivity.

The share of federal tax revenue contributed by corporations has plummeted in recent decades. That places an additional burden on other taxpayers. The massive offshore profit shifting that is taking place today is doubly problematic in an era of dire fiscal crisis. Budget experts across the ideological spectrum are unified in their belief than any serious attempt to address the deficit must include additional federal revenue. Federal revenue, as a share of our economy, has plummeted to historic lows – about 15 percent of GDP, compared to a historic average of roughly 19 percent. The Simpson-Bowles report sets a goal for federal revenue at 21 percent of GDP. The fact that we are today so far short of that goal is, in part, due to multinational corporations avoiding U.S. taxes by shifting their profits offshore.

More than 50 years ago, President Kennedy warned that “more and more enterprises organized abroad by American firms have arranged their corporate structures aided by artificial arrangements … which maximize the accumulation of profits in the tax haven … in order to reduce sharply or eliminate completely their tax liabilities.” So this problem is not new.

But it has gotten worse, far worse. What is the result? Today, U.S. multinational corporations have stockpiled $1.7 trillion in earnings offshore.

It is not a pretty picture. It’s unacceptable. Today we will try to shine a light on some of the transactions and gimmicks that multinationals use to shift income overseas, exploiting tax loopholes and an ineffective regulatory framework.

We will examine the actions of two U.S. companies – Microsoft and Hewlett-Packard – as case studies of how U.S. multinational corporations, first, exploit the weaknesses in tax and accounting rules and lax enforcement; second, effectively bring those profits to the United States while avoiding taxes; and third, artificially improve the appearance of their balance sheets.

The first step in shifting profits offshore takes place when a U.S. company games the transfer pricing process to sell or license valuable assets that it developed in the United States to its subsidiary in a low tax jurisdiction for a price that is lower than fair market value. Under U.S. tax rules, a subsidiary must pay “arm’s length” prices for these assets, but valuing assets such as intellectual property is complex, so it’s hard to know what an unrelated third party would pay. These transactions transfer valuable intellectual property to wholly owned subsidiaries. Multinational companies and the legions of economists and tax lawyers advising them take full advantage of this situation to set an artificially low sale price to minimize the U.S. parent company’s taxable income. The result is that the profits from assets developed in the United States are shifted to subsidiaries in tax havens and other low tax jurisdictions.

It is generally accepted that the transfer pricing process is widely abused and has resulted in significant revenue loss to the U.S. government. In a 2010 report, the Congressional Joint Committee on Taxation wrote that a “principal tax policy concern is that profits may be artificially inflated in low-tax countries and depressed in high-tax countries through aggressive transfer pricing that does not reflect an arms-length result from a related-party transaction.”

Here is a chart depicting Microsoft’s transfer pricing agreements with two of its main offshore groups. As we can see from the chart, in 2011 these two offshore groups paid Microsoft $4 billion for certain intellectual property rights; Microsoft Singapore paid $1.2 billion, and Microsoft Ireland $2.8 billion. But look what those offshore subsidiaries received in revenue for those same rights: Microsoft Singapore group received $3 billion; and Microsoft Ireland, $9 billion. So Microsoft USA sold the rights for $4 billion and these offshore subsidiaries collected $12 billion. This means Microsoft shifted $8 billion in income offshore. Yet, over 85% of Microsoft’s research and development is conducted in the United States.

Another maneuver by Microsoft deserves attention: its transfer pricing agreement with a subsidiary in Puerto Rico. Generally, transfer pricing agreements involve the rights of offshore subsidiaries to sell the assets in foreign countries. The U.S. parent generally continues to own the economic rights for the United States, sell the related products here, collect the income here, and pay taxes here. However, in the case of Microsoft, it has devised a way to avoid U.S. taxes even on a large portion of the profit it makes from sales here in the United States.

Microsoft sells the rights to market its intellectual property in the Americas (which includes the U.S.) to Microsoft Puerto Rico. Microsoft in the U.S. then buys back from Microsoft Puerto Rico the distribution rights for the United States. The U.S. parent buys back a portion of the rights it just sold.

Why did Microsoft do this? Because under the distribution agreement, Microsoft U.S. agrees to pay Microsoft Puerto Rico a certain percentage of the sales revenues it receives from distributing Microsoft products in the United States. Last year, 47% of Microsoft’s sales proceeds in the U.S. were shifted to Puerto Rico under this arrangement. The result? Microsoft U.S. avoids U.S. taxes on 47 cents of each dollar of sales revenue it receives from selling its own products right here in this country. The product is developed here. It is sold here, to customers here. And yet Microsoft pays no taxes here on nearly half the income. By routing its activity through Puerto Rico in this way, Microsoft saved over $4.5 billion in taxes on goods sold in the United States during the three years surveyed by the Subcommittee. That's $4 million a day in taxes Microsoft isn't paying.

It's also important to note that Microsoft's U.S. parent paid significantly more for just the U.S. rights to this property than it received from the Microsoft Puerto Rico for a much broader package of rights.

That's the first step: shifting assets and profits out of the U.S. to a low tax jurisdiction. Next, we move to a second realm of tax alchemy, featuring structures and transactions that require a suspension of disbelief to be accepted.

Once again, the basic rule is pretty straightforward. If a company earns income from an active business activity offshore, it owes no U.S. tax until the income is returned to the United States. This is known as deferral. However, as established under Subpart F of the tax code, deferral is not permitted for passive, inherently mobile income such as royalty, interest, or dividend income. Subpart F should result in a significant tax bill for a U.S. parent company's offshore income. Once the offshore subsidiaries acquire the rights to the assets, they sublicense those rights and collect license fees or royalties from their lower tier related entities – exactly the kind of passive income that is subject to U.S. tax under the anti-deferral provision of Subpart F. But this straightforward principle has been defeated by regulations, exclusions, temporary statutory changes and gimmicks by multinational corporations, and by weak enforcement by the IRS.

On January 1, 1997, the Treasury Department implemented the so-called "check-the-box" regulations, which allow a business enterprise to declare what type of legal entity it wanted to be considered for federal tax purposes by simply checking a box. This opened the floodgates for the U.S. multinational corporations trying to get around the taxation of passive income under Subpart F. They could set up their offshore operations so that an offshore subsidiary which holds the company's valuable assets could receive passive income such as royalty payments and dividends from other subsidiaries and still defer the U.S. taxes owed on them.

The loss to the U.S. Treasury is enormous. During its current investigation, the Subcommittee has learned that for Fiscal Years 2009, 2010 and 2011, Apple has been able to defer taxes on over $35.4 billion in offshore passive income covered by Subpart F. Google has deferred over $24.2 billion in the same period. For Microsoft, the number is $21 billion.

In March 1998, a little over a year after it issued the check the box regulations, the Treasury Department issued a proposed regulation to end the check the box option. The proposal was met with such opposition from Congress and industry groups that it was never adopted. In 2006, in response to corporate pressure to protect this lucrative tax gimmick, Congress enacted the "Look through Rule for Related CFCs," which excludes certain passive income, including interest, rents and royalties, from Subpart F. This provision is currently up for extension.

Now we come to a third level of tax gimmickry. After multinational corporations transfer their assets and profits offshore and place them in a complex network of offshore structures to shelter them from U.S. taxes, some still want to bring those earnings back to the United States without paying taxes.

A U.S. parent is supposed to be taxed on any profits that its offshore subsidiaries send to it. If a foreign subsidiary loans money to a related U.S. entity, that money also is subject to U.S. taxes.

But once again, that simple concept is subverted in practice. The tax code includes a number of exclusions and limitations in the rule governing loans. Short term loans are excluded if they are repaid within 30 days, as are all loans made over the course of a year if they are outstanding for less than 60 days in total. This exclusion allows offshore profits to be used for short term lending – no matter how large the amount – without being subject to U.S. tax.

What's more, if a CFC makes a loan to a related U.S. entity that is initiated and concluded before the end of the CFC's quarter, the loan is not subject to the 30 day limit, and doesn't count against the aggregate 60 day limit for the fiscal year. In addition, the IRS declared that the limitations on the length of loans apply separately to each CFC of a company. So when aggregated, all loans for all CFCs could be outstanding for more than 60 days in total.

Companies have used these loopholes to orchestrate a constant stream of loans from their own CFCs without ever exceeding the 30 and 60 day limits or extending over the end of a CFC's quarter. Instead of being a mechanism to ensure taxes are paid for offshore profits returned to the U.S., the rule has become a blueprint on how to get billions of dollars back into the U.S. tax free.

Take a look at Hewlett-Packard. It has used a loan program to return offshore profits back to the United States since as early as 2003-2004. In 2008, Hewlett-Packard started a new loan program called the "staggered" or "alternating" loan program. Funding for the loans came mainly from two H-P sources, or pools: the Belgian Coordination Center ("BCC") and the Compaq Cayman Holding Corp ("CCHC"). The loans from these two offshore entities helped fund HP's general operations in the U.S, including payroll and repurchases of HP stock.

HP documents indicate that the lending by these two entities was essential for funding U.S. operations, because HP did not have adequate cash in the U.S. to run its operations. In 2009, HP held $12.5 billion in foreign cash and only $0.8 billion in U.S. cash and projected that in the following year that it would hold $17.4 billion in foreign cash and only $0.4 billion in U.S. cash.

The loan program was designed to enable Hewlett-Packard to orchestrate a series of back to back to back to back loans to the U.S. and provide a continuous stream of offshore profits to the United States without paying U.S. taxes. In fact, Hewlett-Packard even changed the fiscal year and quarter ends of one of the lending entities. That way, there could be a continuous flow of loans through the whole year without extending over the quarter end of either of the lending entities.

Just look at the loan schedule that was outlined in a Hewlett-Packard document. Every single day is covered by a loan from a CFC. In FY 2010, for example, HP's U.S. operations borrowed between $6 and $9 billion, primarily from BCC and CCHC, without interruption throughout the first three quarters. There does not appear to be a gap of even a single day during that period where the loaned funds of either BCC or CCHC were not present in the U.S. A similar pattern of continuous lending appears for most of the period between 2008 through 2011.

And what were the loans used for? One Hewlett-Packard power point characterized the loan program as "the most important source of liquidity for repurchases and acquisitions." That doesn't sound like a short term loan program. It was closely coordinated by the Hewlett-Packard Treasury and Tax Departments to systematically and continually fund Hewlett-Packard's U.S. operations with billions of dollars each year since 2008, and likely before that. This loan program is the ultimate example of form over substance. In fact, this is so blatant that internal Hewlett-Packard documents openly referred to this program as part of its "repatriation history" and a "repatriation strategy" – contrary to the notion that this was a short-term loan program.

This scheme mocks the notion that profits of U.S. multinationals are "locked up" or "trapped" offshore. Rather, some of them have effectively and systematically been bringing those offshore profits back by the billions for years through loan schemes like the one described here, and doing so without paying taxes.

The IRS has stated that the substance – not just the form - of offshore loans should be reviewed. So it will also be interesting to hear from the IRS about this loan scheme, and from H-P's auditors at Ernst & Young who approved it.

The subcommittee has examined a fourth level of offshore shenanigans. It involves an accounting standard known as APB 23, which among other things addresses how U.S. multinationals should account for taxes they will have to pay when they repatriate the profits currently held by their offshore subsidiaries.

Under APB 23, when corporations hold profits offshore, they are required to account on their financial statements for the future tax bill they would face if they repatriate those funds. Doing so would result in a big hit to earnings. But companies can avoid this requirement and claim an exemption if they assert that the offshore earnings are permanently or indefinitely reinvested offshore. Multinationals routinely make such an assertion to investors and the Securities and Exchange Commission on their financial reports.

And yet, many multinationals have at the same time launched a massive lobbying effort, promising to bring these billions of offshore dollars back to the United States if they are granted a "repatriation holiday," a large tax break for bringing offshore funds to the United States. On the one hand, these companies assert they intend to indefinitely or permanently invest this money offshore. Yet they promise, on the other hand, to bring it home as soon as Congress grants them a tax holiday. That's not any definition of "permanent" that I understand.

While this may seem like an obscure matter, it is a major issue for U.S. multinational corporations. A 2010 survey of nearly 600 tax executives reported that "60 percent of the respondents indicate that they would consider bringing more cash back to the U.S. even if it meant incurring the U.S. cash taxes upon repatriation, if their company had to record financial accounting tax expense on those earnings regardless of whether they repatriate."

In 2011, more than 1,000 U.S. multinationals claimed this exemption in their SEC filings, reporting more than $1.5 trillion in money that they say is or is intended to be reinvested offshore.

This build up has started to create some problems for many companies. With such a large percentage of their earnings offshore – and a lot of those designated as indefinitely reinvested - they need to figure out ways to finance operations here in the United States without drawing on those earnings. But as the amount of earnings stashed overseas has reached $1.5 trillion, and the need for financing grows back home, there is a real question whether companies can continue to defend their assertions that they have legitimate plans and the intent to continue to indefinitely reinvest those funds, and billions and billions more, overseas.

This situation is also creating a dilemma for their auditors, who sign off on those assertions and plans. In one document, an auditor at Ernst & Young wrote to a colleague:

"Under the APB 23 exception, clients are presumed to repatriate foreign earnings but do not need to provide deferred taxes on those foreign earnings that are 'indefinitely or permanently reinvested.' … If Congress enacts a similar law and companies repatriate earnings that it previously had needed to be permanently reinvested in foreign operations, what effect does that second repatriation have on a future assertion that any remaining earnings are indefinitely or permanently reinvested. An assertion of indefinite or permanent investment until Congress changes the law allowing cheaper repatriation again doesn't sound permanent."

The issue he raises isn't theoretical. Another chart provided by one of the expert witnesses we will hear from today shows what happened to the indefinitely re-invested earnings of the S&P 500 companies after the repatriation holiday was passed in 2004. It shows that the total amount of permanently re-invested earnings declined by $84 billion after the repatriation bill passed. Then, as soon as the repatriation period ended, the total amount of offshore earnings these companies claimed as permanently or indefinitely reinvested skyrocketed again – increasing by 20 % or more in almost every year since 2005.

What does that say about the true intent of those companies? To me, it says this money isn't held offshore for permanent reinvestment. It's there to avoid taxes.

Yet, the auditors who must pass off on the validity of a company's assertion, and the Financial Accounting Standards Board have appeared to go along.

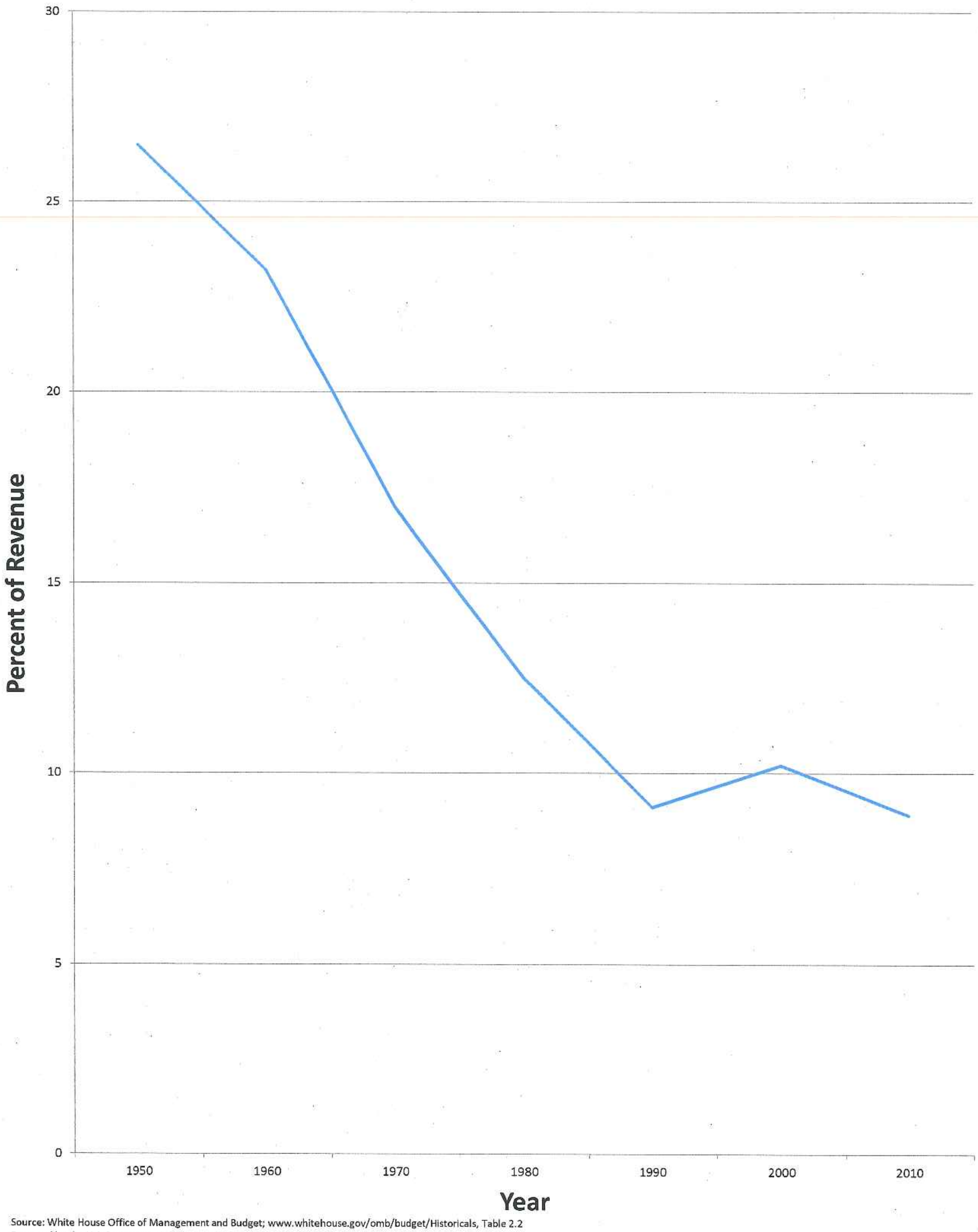
This is an issue we will discuss with them today.

The bottom line of our investigation is that some multinationals use our current tax system to engage in shams and gimmicks to avoid paying the taxes they owe. It is a system that multinationals have used to shift billions of dollars of profit offshore, and avoid billions of dollars in U.S. taxes, to their enormous benefit. Who are the losers in this shell game? There are many:

- The U.S. government, which provides the services and security that help many of those multinational corporations grow and prosper, and then watches them shift their profits offshore to avoid paying taxes;
- Other citizens and business who must shoulder a greater tax burden;
- domestic industries that do not exploit the tax code to shift profits offshore and avoid U.S. taxes;
- the integrity and viability of our tax system.

So today we will take a detailed look at how this system works, the legal contortions on which it is based, its gimmicks and charades, and hopefully, we'll generate some enthusiasm to fix it.

Corporate Income Tax as a Percent of Total Revenue



Source: White House Office of Management and Budget; www.whitehouse.gov/omb/budget/Historicals, Table 2.2
Prepared by the U.S. Permanent Subcommittee on Investigations, Sept .2012.

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EXHIBIT #1b

2011 Microsoft Intellectual Property Payments

(Two Examples)

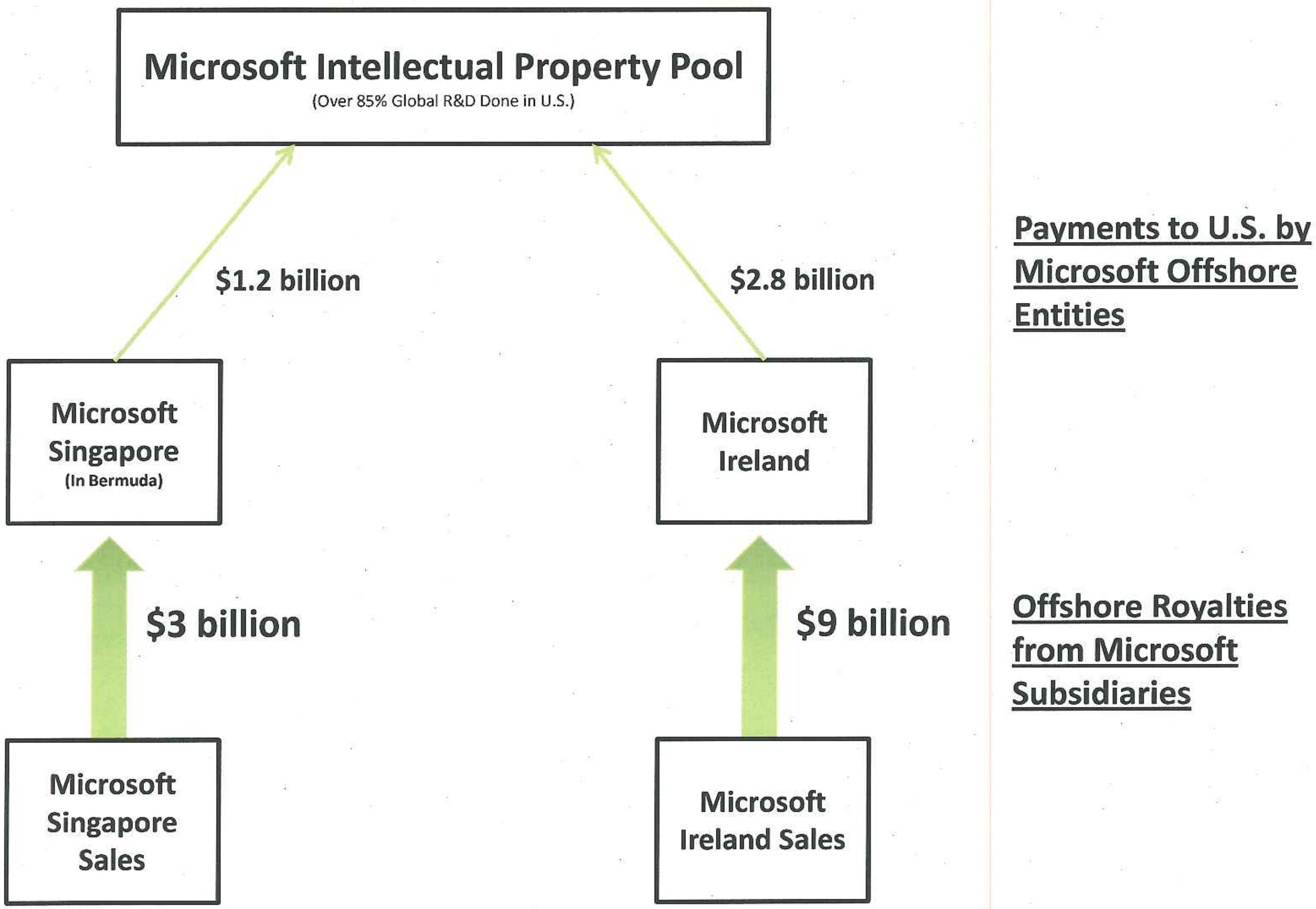

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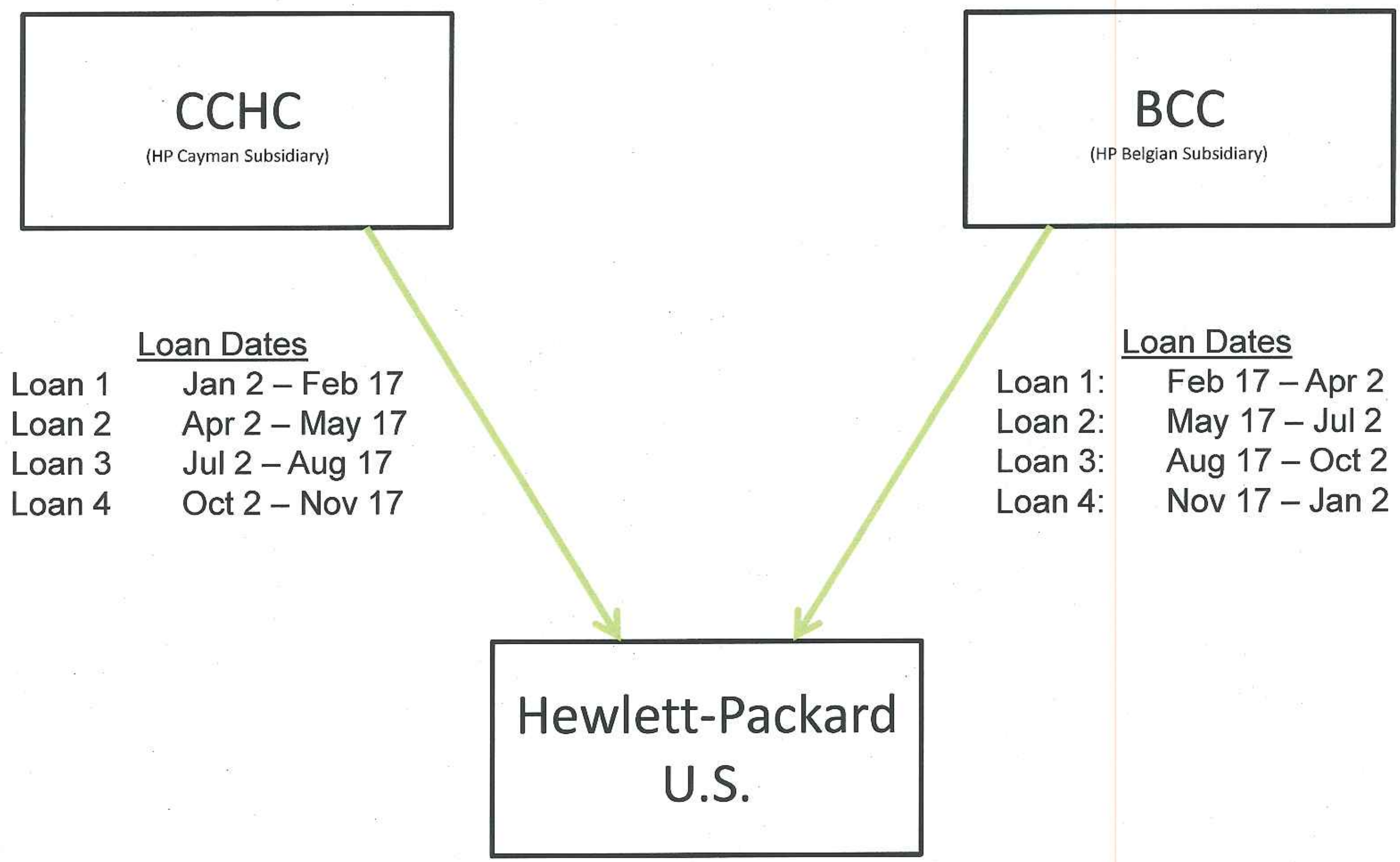
EXHIBIT #1e

Hewlett-Packard
Offshore Alternating Loan Program



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