

**WRITTEN TESTIMONY  
OF  
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BUSINESS & INTERNATIONAL DIVISION  
BEFORE THE  
SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL  
AFFAIRS  
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS  
HEARING ON  
THE SHIFTING OF PROFITS OFFSHORE BY U.S. MULTINATIONAL  
CORPORATIONS  
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Chairman Levin, Ranking Member Coburn and members of the Subcommittee, thank you for the opportunity to testify on tax compliance issues related to the shifting of profits offshore by U.S. multinational corporations. My name is William Wilkins and I am the Chief Counsel for the Internal Revenue Service (IRS). I am accompanied today by Michael Danilack, who is the Deputy Commissioner (International) in the Large Business & International division of the IRS. Mr. Danilack serves as the U.S. competent authority under our bilateral tax conventions, and, more pertinently for today's hearing, has responsibility for international tax enforcement with respect to large business taxpayers.

The subject of today's hearing – the shifting of profits offshore by U.S. multinational corporations – is a multifaceted and somewhat complex subject that can raise tax administration, tax accounting, and tax policy considerations – and perhaps other legal and policy considerations as well. This testimony, however, will be limited to the tax administration considerations raised in the area.

For tax purposes and under basic economic principles, business profits are generally associated with the performance of functions, the assuming of risk, or the employment of assets. With this in mind, it should be noted that this testimony is focused on the shifting by a multinational company of future profits to offshore affiliates through the actual shifting of the underlying functions, risks, or assets that will give rise to those future profits. In other words, this testimony will not address attempts to shift profits realized by a multinational offshore while the income-producing functions, risks, and/or assets are clearly within the U.S. taxing jurisdiction. Such shifts could be attempted through blatant disregard of governing tax and economic principles or through an artifice that might be described as an assignment of income. While, of course, the IRS would and does take enforcement measures regarding the latter class of transactions, this testimony will focus on the more common transactions where future profits are shifted to a related offshore affiliate of a U.S. corporation due to a shift of functions, risks, and/or assets to that affiliate.

The IRS enforcement power in this area arises from section 482 of the Internal Revenue Code. Loosely speaking, pursuant to section 482 and the regulations there under, taxpayers are expected to report the results of transactions between related parties as if those transactions had occurred at arm's length. Thus, when a U.S. corporation sells an asset to an offshore affiliate, or licenses use of an asset to an offshore affiliate, the taxpayer is required to report a sales price, or a royalty rate, based on the price or royalty that would be expected if the transaction had occurred between the U.S. corporation and an unrelated party. A basic tenet under the section 482 regulations, and under international transfer pricing standards, is that the determination of whether the pricing of a transaction between affiliates reflects an appropriate arm's length result is in most cases evaluated by comparing the results of the transaction as reported by the taxpayer to the results realized by unrelated taxpayers engaged in comparable transactions under comparable circumstances.

Applying section 482 to establish an appropriate arm's length price using comparable uncontrolled transactions is relatively straightforward for the vast majority of cross-border transactions, which typically involve transfers of common goods or services. But enforcement difficulties arise in situations in which a U.S. company shifts to an offshore affiliate the rights to intangible property that is core to its business. In fact, over the course of the past decade, applying section 482 in such circumstances has been the IRS's most significant international enforcement challenge.

When the rights to a business's core intangible property are shifted offshore, enforcement of the arm's length standard is challenging for two reasons. First, transfers of such critical business assets outside of a corporate group rarely occur, so comparable uncontrolled transactions are difficult, if not impossible, to find. Thus, the IRS has been forced to resort to other methods that do not require direct evidence of comparable uncontrolled transactions, such as income-based methods that depend on an *ex ante* discounted cash flow analysis, which in turn depends on evaluating financial projections developed by the taxpayer. Second, because a business's core intangible property rights are by nature "risky" assets, projecting cash flows from such assets, and the appropriate discount rate, requires an inherently challenging assessment of the underlying risk and how, and by which party, that risk is borne.

As cross-border business restructurings involving shifts of intangible property rights became more commonplace in the early 2000s, the IRS responded by forming teams of experts known as issue management teams (IMTs) to focus on the section 482 challenges just described. In 2005, an IMT was dedicated to cost-sharing transactions and a second IMT was formed to focus on certain transactions commonly referred to as section 936 exit strategies. These teams were comprised of IRS transfer pricing specialists and Chief Counsel attorneys, and were led by IRS executives, who centrally managed the "inventory" of examinations involving transactions in these respective areas. The teams ensured that IRS resources were appropriately dedicated to these examinations, that best practices and processes were shared, and that the IRS position on the underlying issues was applied uniformly to cases under similar facts and circumstances.

In a further important development, the Treasury Department and the Office of Chief Counsel issued in 2008 a new set of section 482 regulations pertaining to cost-sharing transactions. These temporary regulations, which became effective on January 5, 2009 (and were finalized in 2011), clarify a number of issues that had been contentious under the previous set of cost-sharing regulations and better define the scope of intangible property contributions that are subject to taxation in connection with cross-border business restructurings. While to date the IRS has had limited experience in auditing transactions covered by the new regulations, early anecdotal information indicates that the regulations have had a positive impact on taxpayers' reporting positions in the area. As an important complement to the cost sharing regulations, in 2009 the Treasury Department and the Office of Chief Counsel also finalized regulations covering service transactions, including services performed using high value intangibles.

In addition, the IRS has continued to marshal, coordinate, and augment its resources dedicated to transfer pricing enforcement. In 2011, a new executive position was created to oversee all transfer pricing functions, to set overall strategy in the area, and to coordinate work on our most important cases. In building a new function devoted exclusively to tackling our transfer pricing challenges, within the past year we have been able to recruit dozens of transfer pricing experts and economists with substantial private sector experience who are now working hard to help us stay on the cutting edge of enforcement and issue resolution. This new transfer pricing operation will operate as a single, integrated team with a global focus, a unified strategy, and a robust knowledge base. As this function will focus on all strategic transfer pricing matters, we were able to disband the more discrete, ad hoc issue management teams discussed above.

## **CONCLUSION**

Mr. Chairman, thank you again for this opportunity to testify regarding the IRS's efforts to enforce our transfer pricing laws and regulations as they relate to the profit shifting topic addressed in today's hearing. Although enforcing and administering section 482 will present challenges for the IRS into the future, we strongly believe the agency has made great strides in recent years and that this is a tribute to the highly dedicated and professional men and women of the IRS. We would be happy to answer your questions.