NATIONAL ASSOCIATION OF Manufacturers

*Leading Innovation. Creating Opportunity. Pursuing Progress.*

# Statement

**of The National Association of Manufacturers**

*before the* House Ways and Means Committe

*on* Transfer Pricing Issue

July 22, 2010

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The National Association of Manufacturers (NAM) welcomes the opportunity to submit a statement for the record of the House Ways and Means Committee hearing on transfer pricing issues. As the nation's largest industrial trade association, the NAM represents small and large manufacturers in every industrial sector and in all 50 states.

Manufacturers have a strong interest in our nation's international tax regime in general and transfer pricing in particular. Almost half of American worldwide companies are manufacturers and 53 percent of all U.S. manufacturing employees are employed by American companies with operations overseas.

Transfer pricing—the price charged in transactions between related entities— is of particular interest to manufacturers as innovators because much of the transfer pricing debate focuses on transactions involving intangible assets. U.S. manufacturers perform half of all R&D in the nation, driving more innovation than any other sector.

**Transfer Pricing and Competitiveness**

With more than 95 percent of the world's customers outside the United States, a growing number of manufacturers are establishing operations abroad to penetrate foreign markets and expand their businesses. This globalization has increased the importance of our international tax rules, including transfer pricing. U.S. companies frequently find themselves competing in markets with non-U.S. companies that face lower tax burdens.

In order to stay competitive and avoid double taxation, U.S. manufacturers are forced to seek efficiencies in how and where they operate, increasing the number and complexity of intercompany and cross-border transactions. Consequently, transfer pricing is one of the leading international issues currently facing worldwide American companies.

Despite allegations by some that the transfer pricing rules are used to "shift income overseas," and reduce U.S. taxes, the data and statistics to support these assertions are weak. In his prepared testimony to the Committee, James R. Hines Jr, Professor at the University of Michigan School of Law in Ann Arbor, Michigan, notes, that while no enforcement issue is without challenges, "there is not any reliable evidence

of the magnitude of lost U.S. revenue, and there is ample reason to believe that many studies greatly exaggerate the magnitude of the potential problem."

**The Arm's Length Standard**

Manufacturers agree with the Administration that the current arm's length standard— embodied in U.S. tax law and tax treaties—is the appropriate standard for transfer pricing. Basing intercompany pricing on what unrelated third parties would do under the same or similar circumstances is a fundamental principle of tax policy. The arm's length standard has been, and remains, conceptually sound, relevant and reliable in addressing related party transactions.

Transfer pricing transactions involve at least two jurisdictions and the arm's length standard recognizes the natural "tension" when each jurisdiction is interested in maximizing revenue and discouraging "leakage" from its tax base. In addition, a system of "advance pricing agreements," a mechanism whereby governments agree to pricing arrangements in advance, provides certainty both to the governments and taxpayers. The arm's length standard has been adopted by the Organization for Economic Cooperation and Development (OECD) and is used by every major industrial nation.

Moreover, there is a well-developed body of law and regulatory guidance on the standard in the United States. For example, over the years, Treasury has issued numerous regulations and other guidance on issues involving transfers of intangible assets, including inventions, scientific discoveries, patents, designs, trademarks, brand names, and copyrights. In addition, the Internal Revenue Service (IRS) has broad authority to audit intercompany transactions and change the results reported on tax returns, even absent intent to evade or avoid taxes.

Contrary to critics of the arm's length standard, recent activity in the U.S. Competent Authority Office does not support allegations that American companies are shifting income overseas. Since 2001, the U.S. Competent Authority office has handled many more double tax cases involving foreign-initiated transfer pricing adjustments than U.S.-initiated adjustments, reflecting the concerns of foreign tax authorities in our treaty network who think American companies are reporting too much income in the United States and too little in their jurisdictions. In 2009, for instance, the U.S. Competent Authority received 158 transfer pricing double-tax cases; 134 were foreign-initiated adjustments, 24 were U.S.-initiated.[1]

NAM members are opposed to proposals that would replace the arm's length standard with formulary apportionment. Under this system, formulas would be used to assign jurisdiction-based profit based on ratios of sales, property and/or employees. These measures of formulary apportionment, which focus on averages rather than arm's-

[1] Foreign-Initiated Adjustments, Inventory of U.S. Double Tax Cases Top Prior Levels, 18 Transfer Pricing Report 1008 (Jan. 28, 2010).

length transactions, do not necessarily correlate to the true economics of where income is earned and often increase the risk of double taxation.

The formulary approach currently is used by a number of states in taxing multistate income, although even among the states there is no consensus on the factors to be used and the weight afforded to each. To date, no country has adopted formulary apportionment. Based on the experience in several U.S. states, if individual countries did adopt this approach they would not necessarily use identical formulas and would be interested in "maximizing" their share of income tax revenue.

**Changing the Rules Outside of Tax Reform**

NAM members also oppose several transfer pricing–related proposals in the Administration's fiscal 2011 budget proposal. One proposal, which would tax currently the "excess returns" generated by intangible assets in a "low tax" jurisdiction, is contrary to the arm's length standard and overlooks industry realities. The change—estimated to increase taxes on worldwide American companies by almost $16 billion over ten years—would effectively eliminate deferral for that income. The proposal supersedes the transfer pricing rules without regard to the underlying facts and circumstances, is contrary to the arm's length standard and by applying an arbitrary "rate of return" formula based on the tax rate of the foreign jurisdiction, ignores the underlying economics of the taxpayer's position.

Another revenue raiser in the Administration's budget would expand the definition of intangible property covered by the transfer pricing rules to include workforce in place, goodwill and going concern value. This proposal—which is estimated by the Administration to raise some $1.2 billion over ten years— also raises concerns for manufacturers. Far from being a mere clarification as the Administration suggests, the proposal would extend taxation beyond transfers of actual property rights, to transfers of entirely amorphous qualities that are not even legally protected. In so doing, the proposal would impose a significant new competitive burden on U.S.-based multinational companies and would usher in a new era in complexity for taxpayers and for the IRS in administering the transfer pricing rules.

For example, a U.S.-based multinational company would no longer be able to move teams of key executives from one location to another as business needs may dictate without having to contend with the possibility that the IRS may assert that such a move may constitute a taxable outbound transfer of a "workforce in place" intangible, triggering unexpected tax burdens and possibly even penalties. The Tax Court in the *Veritas* case soundly rejected IRS attempts to read such misguided concepts into present law, and the Congress should reject the Administration's proposal to add them to the statute.

The proposal also includes other supposed clarifications that would have the effect of codifying IRS audit and litigating positions, allowing the IRS to aggregate separate intangibles for valuation purposes and to make transfer pricing allocations based

on a taxpayer's "realistic alternatives," as opposed to the transaction actually undertaken by the taxpayer. These changes also would introduce new complexity and competitive burdens on U.S.-based taxpayers and should be rejected.

Overall, these proposals—and other international provisions in the President's FY 2011 budget—would make manufacturers even less competitive in the global marketplace. We strongly disagree with comments by the Administration during the Committee's hearing on July 22, 2010, that these proposals would not negatively affect a company's decision to pursue its R&D in the United States. The imposition of over $17 billion in tax increases on innovation developed and maintained in the United States strongly suggests that many companies would reevaluate the location of their R&D activities. There are many countries around the world with world class R&D platforms that would welcome more U.S. R&D investment. These countries know firsthand that R&D fuels innovation that translates into new products, increased productivity and jobs. The potential loss of U.S. R&D would have a negative impact on U.S. jobs and our overall economic growth.

The United States is an exception among major industrial nations in taxing a company's global income rather than using a territorial system of taxation. The global nature of the U.S. tax system coupled with a high statutory corporate tax rate already poses special challenges for manufacturers and other American businesses trying to compete in a global marketplace.

Manufacturers support efforts to reform the nation's tax laws and believe strongly that changes to our international tax laws should be considered in the broader context of tax reform that makes the United States more competitive. Targeting international tax law changes—like the proposals to tax excess returns and expand the definition of IP—in advance of the tax reform debate could make the goal of pro-growth, pro-competitiveness reform that much more difficult, if not impossible, to achieve.

**Tax Policy for Jobs and a Competitive America**

In June 2010, the NAM unveiled a *Manufacturing Strategy for Jobs and a Competitive America,* a comprehensive view of what is needed for manufacturing to succeed in the global marketplace. One of the key recommendations outlined by the NAM strategy is the need for tax policies that bring the United States more closely into alignment with major manufacturing competitors.

In particular, the strategy calls for reducing the corporate tax rate to 25 percent or lower, promoting fair rules for taxation of active foreign income of U.S. businesses and a permanent, strengthened R&D credit. More broadly, we call on policymakers to create a national tax climate that does not place manufacturers in a competitive disadvantage in the global marketplace and to acknowledge that raising taxes makes manufacturers less competitive.

We appreciate the Committee's interest in and focus on tax policy issues that impact our global competitiveness. However, the proposed changes to the current transfer pricing rules discussed above—a formulary apportionment system, eliminating deferral for "excess profits," and expanding the definition of intangible property—will make U.S. manufacturers even less competitive. Any projected federal revenue gains would be illusory as American companies face an uphill struggle that their competitors who operate under modern territorial systems would not suffer. Manufacturers look forward to working with the Committee on pro-growth, pro-manufacturing tax policy.

Supplemental Sheet

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