

# **How Should the United States Address International Income Shifting?**

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# Does the arms length standard make sense in today's economy?

Problem: Not suited to a global economy.

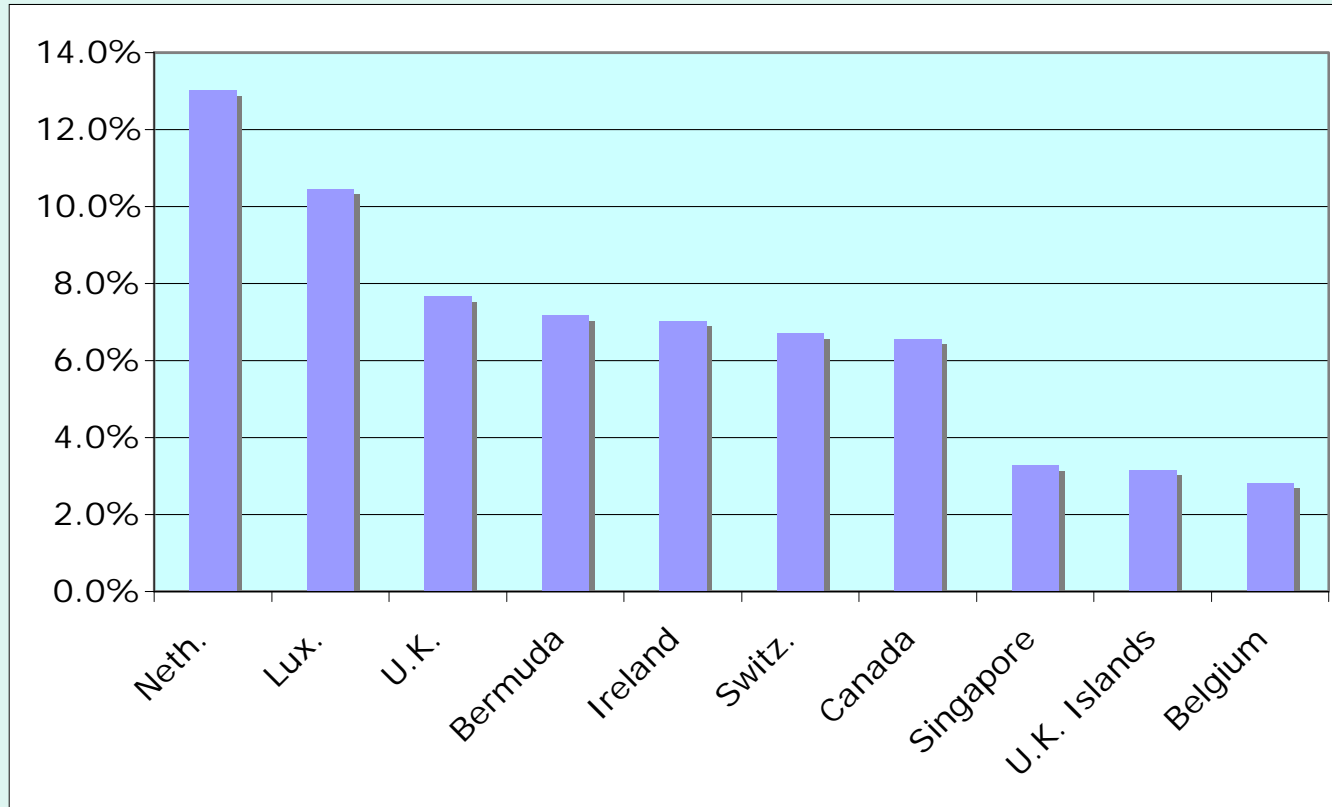
- Multinational firms based on organization, internalization advantages  
=> no conceptual justification; comparables don't exist
- Global integration  
=> huge practical problems
- Inherently complex => huge compliance and administrative costs; some attempts to tighten rules make this worse

# Does the arms length standard make sense today?

Problem : Incentive to shift income and economic activity => inefficiency and tax competition concerns

- There is a wealth of empirical support for these incentives, direct and indirect evidence, meta-analysis
- Statements of income have less meaning than we'd like
- Large revenue consequences
- Likely effects on economic activity

# Example of Profit Shifting: Where are U.S. MNC Profits in 2005?



# Tax Rates of High Income Countries

<b>Country</b>	<b>Effective Tax Rate</b>
Netherlands	5.1%
Luxembourg	0.9%
United Kingdom	28.9%
Bermuda	0.9%
Ireland	5.9%
Switzerland	3.5%
Canada	21.4%
Singapore	3.2%
U.K. Islands	1.9%
Belgium	8.7%

# Policy Options

- Eliminate deferral
- Harmonize tax rates
- Encourage non-abusive transfer prices

Still, problem may require a more comprehensive approach.

# Formulary Apportionment

- Tax base is worldwide income, independent of residency
- Fraction taxable at home depends on formula
- Formula based on sales, assets, or payroll; I've advocated sales only in the past
- Similar to U.S. state system
- Europeans consider similar idea: the CCCTB
- Another option is a formulary profit split; similar to “residual profit split” method

# Key Advantages

- No income shifting
- Suited to globally integrated world economy
- Tax Base independent of residence, legal form
- Simpler : no need to allocate income/expenses, no deferral, no subpart F or other CFC rules, no foreign tax credit, no taxation of foreign source income, no transfer pricing regimes!
- Less tax competition: high-tax countries would gain revenue or could lower rates
- Unlikely we'd be further from “real” income allocation; deal with intangibles by leaving out of formula

# Downsides

- Factors in formula may be tax responsive => design is important
- But remember hierarchy of behavioral response; a *big lesson of public finance*
- Possible Merger/Acquisition/Divestiture incentive
- Low tax countries lose revenue
- International coordination ideal though difficult