Letter from Jeffery M. Kadet to Technical Director, Financial Accounting Standards Board (Feb. 7, 2020) on Income Taxes (Topic 740) Proposed Accounting Standards Update (Revised)

Jeffery M. Kadet
University of Washington School of Law

JEFFERY M. KADET
511 W Prospect St
SEATTLE WA 98119
(206) 285-1324
JEFFKADET@gmail.com

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Technical Director
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FASB
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
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Re: Income Taxes (Topic 740) Proposed
Accounting Standards Update (Revised)
March 25, 2019

Dear Director Kuhaneck and Members of the Board:

There is a critical need to expand required disclosures for multinational groups (MNCs) under generally accepted accounting principles. In particular, to have any hope of assessing the potential for tax risk and management's relative aggressiveness in managing its tax obligations to governments around the world, all stakeholders urgently need the information that country-by-country reporting (CbCR) and the other suggestions made in this letter would provide. As is set out below, many MNCs carry material tax risks from their adoption over the past several decades of increasingly aggressive and sometimes questionable profit-shifting structures that seriously divorce legal form and reality.

This letter discusses:

- Background on profit-shifting structures (page 2),
- Need for CbCR – How CbCR would benefit stakeholders without creating undue compliance issues for MNCs (page 7),
- Need for guidance on location in connection with new paragraph 740-10-50-10A (disaggregation of income or loss from continuing operations between domestic and foreign) (page 11), and
- Disclosures Concerning Unrecognized Tax Benefits (page 15).

The primary message that this letter wishes to convey is that multinational corporations currently operate under a range of U.S. and foreign tax exposures, and CbCR information is critical for investors and other users of financial reports to assess:

- The potential for material tax assessments,
- Possible reputational and other commercial risks that could arise from aggressive tax structures, and
- Management's relative conservatism or aggressiveness with respect to tax matters.

FASB should be a leader in developing appropriate accounting standards to increase corporate tax transparency in financial reports. If FASB does not take a leadership role, others including governments, international bodies, and private sector entities will design the global standards mandating increased corporate tax disclosures.

Personal Background and Basis for Contributing to this Discussion

I submit this letter and make recommendations based on what I personally believe is best for the integrity of our financial reporting system and its stakeholders. I have no "agenda" or "biased interest", such as the many commentators have who are currently employees of, or paid advisors to, our MNCs, many of which do have a direct or indirect interest in the outcome of these current deliberations. I have not been a paid advisor to MNCs for well over a decade.

Regarding my background and ability to comment on this complex topic of international taxation and financial reporting, I was in private practice working for over 32 years in international taxation for several of the major international accounting firms both in the U.S. and abroad, giving tax advice to MNCs headquartered in the U.S. and other developed countries. I have also created and taught over almost two decades several international taxation courses within the Tax LLM program at the University of Washington School of Law.

Background on Profit-Shifting Structures

I have authored or co-authored a series of articles[1] focused on the application of certain U.S. taxation to profit-shifting structures commonly used by MNCs that are operationally

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[1] (a) Jeffery M. Kadet, ''Attacking Profit Shifting: The Approach Everyone Forgets'', Tax Notes, July 13, 2015, p. 193. (http://ssrn.com/abstract=2636073)
(b) Jeffery M. Kadet and David L. Koontz, ''Profit-Shifting Structures and Unexpected Partnership Status'', Tax Notes, Apr. 18, 2016, p. 335. (http://ssrn.com/abstract=2773574)
(c) Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, ''Profit Shifting: Effectively Connected Income and Financial Statement Risks'', 221 J. Acct. 48 (Feb. 2016). (http://ssrn.com/abstract=2728157)
(d) Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively", Tax Notes, June 27, 2016, p. 1831, and July 4, 2016, p. 85. (http://ssrn.com/abstract=2811267 and http://ssrn.com/abstract=2811280)
(e) Jeffery M. Kadet and David L. Koontz, "Internet Platform Companies and Base Erosion—Issue and Solution", Tax Notes, December 4, 2017, p. 1435. (http://ssrn.com/abstract=3096925)
(f) Jeffery M. Kadet and David L. Koontz, "Effects of the New Sourcing Rule: ECI and Profit Shifting", Tax Notes, May 21, 2018, p. 1119.(http://ssrn.com/abstract=3201365)
(g) Jeffery M. Kadet, "Sourcing Rule Change: Manufacturing and Competitiveness", Tax Notes, November 5, 2018, p. 717. (http://ssrn.com/abstract=3296763)
(h) Jeffery M. Kadet and David L. Koontz, "Transitioning from GILTI to FDII? Foreign Branch Income Issues", Tax Notes Federal, July 1, 2019, p. 57. (http://ssrn.com/abstract=3428540)

headquartered in the U.S. These MNCs include not only U.S.-based MNCs, but also certain foreign-based MNCs that have their parent corporation legally established outside the U.S. Such foreign-based MNCs include, for example, former U.S.-based MNCs that have "inverted" and private equity and other investor acquisitions of U.S.-based MNCs that are made through a foreign acquisition vehicle. Both types of foreign-based MNCs are specifically structured to avoid U.S. and other country taxation by having a foreign parent in a zero or low-effective tax location.[2] Despite their foreign-based structures, following an inversion or acquisition, the U.S.-based management and operations remain basically unchanged. In addition, in some cases foreign-based MNCs with their own substantial operations outside the U.S. will make strategic acquisitions of U.S.-based MNCs and leave the U.S. management and operations intact.

Such structures both in pre-TCJA[3] years and currently have the dual goals of:

- Avoiding taxation in the mid- and high-tax foreign countries in which MNCs operate, and
- Significantly reducing or completely avoiding any U.S. taxation.

These structures typically exhibit three economic and operational factors:

- Value drivers in the U.S.;
- Control and decision making in the U.S.; and
- Lack of a foreign group member CEO and management outside the U.S. that are capable of operating an independent stand-alone business.

In today's environment, most MNCs conduct their worldwide businesses through centralized management and integrated business operations. Prior to the development of the internet and real-time global communications, however, MNCs conducted their businesses through relatively independent subsidiaries located in various countries around the world. Each such subsidiary would have its own management and operations personnel. It was in this environment that the international tax rules were developed and in which they allowed taxation to appropriately be imposed in the countries where these subsidiaries conducted their businesses.

With the rise of 21st century communications, most MNCs have increasingly centralized both management and business operations, causing over the last two to three decades these previously independent subsidiaries to transform into mere cogs within integrated worldwide structures. As mere cogs, these subsidiaries are no longer run independently. Rather, they perform only limited assigned functions and are no longer independently run businesses that stand on their own. Such limited functions can include contract manufacturing, research and development services, raw material and component sourcing, marketing, sales, distribution, etc.

Despite MNCs having developed new centralized and integrated structures, there has been no change or modernization of international tax rules. As a result, many MNCs adopted new legal structures to achieve zero or low taxation on significant portions of their profits. They did this not through operational changes, but rather through altered internal relationships and

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[2] Such inversions or private equity acquisitions typically use corporate vehicles in tax havens or territorial jurisdictions that do not tax foreign earnings.

[3] The Tax Cuts and Jobs Act (TCJA) was enacted in December 2017 and is generally effective for 2018 and subsequent years.

intercompany pricing executed through intercompany contractual arrangements that often had no significant purpose aside from tax avoidance.[4]

Profit-shifting structures have most often involved intra-group transfers of intangibles to foreign group member entrepreneurs that then record third party revenues from services and product sales. Where manufacturing is involved, these entrepreneurs will often source products directly from contract manufacturers and perform little or no manufacturing functions themselves. Rather, such functions are performed mostly, if not fully, by U.S. group members. Such functions can include, for example, identifying sources of raw materials and components, negotiating terms including pricing with such sources, identifying and negotiating with contract manufacturers, determining production timing and costs, controlling inventory levels, quality control, etc.

In the case of foreign group member entrepreneurs recording revenues through internet platforms that involve sales of intangible products or cloud services (e.g. software, cloud storage, advertising, gig economy services, sales agent functions, etc.), typically U.S. group members actually manage and conduct the day-to-day operations that maintain and operate the revenue generating internet platforms. Most if not all of the DEMPE function are conducted by U.S. group members. (The DEMPE functions include the development, enhancement, maintenance, protection, and exploitation of intangibles.)

In these cases, entrepreneur group members record profits at levels that reflect (i) their legal ownership or other rights to all relevant intangibles, and (ii) their contractually bearing all commercial risks. However, their own personnel typically conduct only a portion, if any, of the commercial and risk-control functions that are critical to the entrepreneur's business. Rather, many or all of such functions are performed by U.S. group members. These functions can include marketing and other revenue-related functions, production functions for manufactured products (typically all production functions short of the physical manufacturing, which is often performed by unrelated contract manufacturers), and the DEMPE functions with respect to internet platforms and other intangibles. Despite being critical functions integral to the entrepreneur's business and undertaking of risk, they are partially or fully performed by U.S. group members under independent contractor arrangements that often return only a small mark-up on cost to the U.S. group members, thereby leaving the bulk of the profits within the entrepreneur.[5]

The IRS has attacked such structures through transfer pricing and re-characterization adjustments. For example, the IRS has questioned the transfer price for intangibles transferred

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[4] For additional discussion of the background to the rise of aggressive profit-shifting structures, see section II of Jeffery M. Kadet, "BEPS: A Primer on Where It Came From and Where It's Going", 150 *Tax Notes* 0793 (February 15, 2016), available at http://ssrn.com/abstract=2739659.

[5] It is fair to say that many non-tax expert MNC directors and management personnel have little ability to really assess the relative aggressiveness of their own MNC's profit-shifting structures. In 2016, my co-author and I proposed an objective ethical benchmarking tool that could be applied by such non-tax experts. This tool could be used to better assess the need for FIN 48 disclosures and accruals. See part III of Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively", *Tax Notes*, June 27, 2016, p. 1831, and July 4, 2016, p. 85, available at http://ssrn.com/abstract=2811267 and http://ssrn.com/abstract=2811280. Taking CbCR information that is now only confidential tax information and making it easily available to all directors and management personnel by placing it within financial statements would considerably improve their ability to assess their MNC's tax structures.

from U.S. group members to foreign group members (e.g. Facebook, Microsoft, etc.). It has also questioned the characterization of structures through "substance versus form" or assignment of income doctrines (e.g. Caterpillar).

The attached peer-reviewed article,[6] from the February 2016 issue of the Journal of Accountancy (JofA), raises another approach under which the IRS can attack profit-shifting structures. It was written for CFOs, in-house tax professionals, and outside auditors. It considered the application of the U.S. effectively connected income (ECI) rules to profit-shifting structures and relevant financial and tax consequences.[7] There is no need to repeat in detail in this letter how the ECI rules work as that is sufficiently covered in the JofA article.[8] In brief, though, where applicable, ECI taxation imposes U.S. corporation tax at normal corporate rates (plus where applicable an additional up-to-30% "branch profits tax"[9]) on some portion of the shifted profits that MNCs have recorded within their foreign group member entrepreneurs. This is a *direct* tax since the taxpayer is the foreign group member.[10] As a result, the statute of limitations that normally applies to U.S. group members applies separately to any such foreign group member. Because foreign group member entrepreneurs will not normally have filed U.S. tax returns, early years going back to the initiation of a profit-shifting structure will often still be open to adjustment by the IRS.[11] FIN 48 would apply as well to require potential disclosures and accruals.

In addition to possible assessments by the IRS against profit-shifting structures through transfer pricing adjustments, re-characterization, or ECI taxation, there are also possible claims by foreign tax authorities. The reality of material tax exposure in multiple countries has been clearly demonstrated by the reporting over the past decade of many instances of assessments in the hundreds of millions of dollars (see a few included in the footnote).[12] The most well-known of

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[6] Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, ''Profit Shifting: Effectively Connected Income and Financial Statement Risks'', 221 *J. Acct.* 48 (Feb. 2016), available at http://ssrn.com/abstract=2728157.

[7] For the most part, the December 2017 Tax Cuts and Jobs Act did not change these rules. For detailed discussion of the pre- and post-TCJA effects, see section II of Koontz and Kadet, "Effects of the New Sourcing Rule: ECI and Profit Shifting", 159 TN 1119, May 21, 2018, available at http://ssrn.com/abstract=3201365.

[8] Any reader looking for additional detail on ECI taxation and profit-shifting structures beyond that included in the JofA article should see Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets", 148 *Tax Notes* 0193 (July 13, 2015), available at http://ssrn.com/abstract=2636073.

[9] See Internal Revenue Code §884.

[10] This is in contrast to taxable income recognized by U.S. group members as a result of transfer pricing adjustments or U.S. shareholder income inclusions under the controlled foreign corporation provisions in the U.S. Internal Revenue Code.

[11] For example, in 2014, hearings were conducted by the Senate Permanent Subcommittee on Investigations on Caterpillar's offshore tax strategy. This strategy was initiated in 1999. If relevant U.S. tax returns were not filed and the IRS audited Caterpillar on this issue, then the IRS could assess tax against certain Caterpillar foreign group members on their ECI going back to the 1999 initiation of the structure. Committee documents are available at https://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy.

[12] A few examples of such assessments will provide an understanding of why there are significant tax risks of which all interested stakeholders need to be aware. While not all foreign adjustments are caused by mismatches between where taxable income is reported and where revenues are earned and operations take place, such mismatches do account for many foreign tax adjustments. The following are examples of just a few foreign adjustments: (1) Apple Europe Ltd paid to the U.K. a corporate income tax adjustment of £137 million covering prior years up to September 26, 2015. See Stephanie Soong Johnston, "Apple Pays Extra £137 Million in U.K. Corporation Tax", 2018 WTD 8-2 (January 11, 2018). (2) In late 2018, Irish tax authorities issued an assessment for over €1.63 billion to an Irish subsidiary of Perrigo Pharma International. See Amanda Athanasiou, "Pharmaceutical

these assessments is the Apple State Aid assessment that was originally set at €13.1 billion plus interest of €1.2 billion. It was recently disclosed in Apple's September 28, 2019, Form 10-K and its December 28, 2019, Form 10-Q that this €13.1 billion assessment had been reduced by approximately €190 million due to taxes that have been paid to other countries, presumably following various tax authority audits in those countries.[13]

As a final comment, government policymakers around the world (now through the almost 140 country Inclusive Framework[14]), NGOs, investors, analysts, employees, academics, and others evaluating the behavior of public business entities and their managements increasingly focus on the use of artificial structures that shift profits into tax havens and other low-tax jurisdictions. Because of the G20/OECD lead Base Erosion and Profit Shifting project that has been effectively ongoing since 2013, country-by-country reporting is already a requirement for tax purposes.[15] As such, there should be no material additional costs for MNCs to provide such information in their U.S. financial reports.

Many around the world are already demanding *public* country-by-country reporting.[16] This is in contrast to the current opaque CbCR that is only submitted to relevant tax authorities. FASB should be ahead of the curve on this and be a leader in developing appropriate standards for disclosure. If FASB merely follows the mantra of vocal GAAP-reporting public business entities that seek to retain the present opaque walls around internal structuring and tax planning, it will end up being not a leader, but rather a follower as governments and other bodies take the initiative to mandatorily require increased disclosures. This is not a time to allow public business entities to guide the discussion; it's a time for FASB to do what's best for all stakeholders and society as a whole.

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on the Hook for Over €1.63 Billion in Ireland", 2018 WTD 247-9 (December 26, 2018). (3) In late 2019, an Australian subsidiary of Google agreed to increased taxes of about US$330 million to settle a dispute with the Australian tax office. See William Hoke, "Google to Pay $330 Million to Settle Australian Tax Dispute", 2019 TNTI 244-4 (December 19, 2019). (4) In various years, Facebook, Amazon, Google, and Apple paid adjustments to Italy of, respectively, over €100 million, €100 million, €306 million, and €318 million. See William Hoke, "Facebook Settles Italian Tax Dispute for Over €100 Million", 92 *Tax Notes Int'l* 1013 (December 3, 2018). (5) As a final example, an Australian Tax Office Commissioner was reported to have explained the disconnect between where income is earned and where it is reported. "In testimony before the committee that year, ATO Commissioner Chris Jordan challenged Microsoft's assertion that profits on its Australian sales were primarily earned in Singapore, with AUD 2 billion reported in Singapore and only AUD 100 million in Australia. Jordan said at the time that the ATO was trying to determine whether the revenue split reported by the company was appropriate. Jordan also said that a significant part of the Singapore profits was paid out as technology fees and ended up in a Microsoft affiliate in Bermuda." See William Hoke, "Microsoft and Apple Settle Australian Corporate Tax Audits", 87 *Tax Notes Int'l* 850 (August 28, 2017).

[13] See page 46 of Apple Inc.'s 2019 Form 10-K and page 16 of Apple Inc.'s Q1 2020 Form 10-Q.

[14] See https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

[15] See the October 5, 2015, Final Report of the BEPS project on Action 13 concerning country-by-country reporting at https://www.oecd.org/tax/beps/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm. Also, see Treasury Regulation §1.6038-4, which implements CbCR on certain U.S.-based MNCs.

[16] See, for example, https://www.globalreporting.org/standards/work-program-and-standards-review/disclosures-on-tax-and-payments-to-government/, https://home.kpmg/xx/en/home/services/tax/regional-tax-centers/eu-tax-centre/country-by-country-reporting.html and https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/public-country-country-reporting_en.

Need for CbCR

The IRS has attacked MNC profit-shifting structures in an indirect manner through transfer pricing adjustments (e.g. Facebook, Microsoft, etc.) and re-characterization (e.g. Caterpillar). The above-mentioned series of articles (see footnote 1) shows how in many cases high U.S. taxes should be imposed directly on the zero and low-taxed foreign group members into which profits have been shifted. Finally, the foreign countries in which MNCs operate and from which they earn revenues have actively attacked these profit-shifting structures.

For all of these U.S. and foreign tax exposures, CbCR information is critical for stakeholders to assess the potential for material tax assessments, possible reputational and other commercial risks that could arise from aggressive tax structures, and management's relative conservatism or aggressiveness with respect to tax matters.

CbCR, more than any other tool, highlights mismatches between the countries within which an MNC records profits and the MNC's factual situation of where it has personnel and tangible assets earning those profits. Such mismatches highlight the potential risks of transfer pricing adjustments, ECI taxation, and foreign tax adjustments.

Risks, of course, will be more relevant and significant when there are high recorded profits in zero or low-tax locations with few personnel and tangible assets while U.S. and other foreign operating group members have high levels of personnel and tangible assets, but relatively lower levels of recorded profits, or even losses. Without CbCR reporting, there will be little information in financial statements on which stakeholders may make informed judgments. This is due to the fact that most profit-shifting structures are put in place through the formation of multiple group members that make intercompany transfers of intangible assets and execute intercompany agreements, all of which disappear in consolidated financial reporting.

A brief example using Apple, a company well known to many, will be instructive and will emphasize the importance and relevance of CbCR to stakeholders.

As has been seen from the above Background discussion, Apple has been a target of foreign tax authorities including the European Commission. Although there is no evidence that its tax structuring has been questioned by the IRS, Apple's international structure was closely examined in certain 2013 hearings conducted by the Senate Permanent Subcommittee on Investigations (PSI).[17] While not suggesting that Apple had done anything illegal, some of those at the hearings were less than complementary about Apple's structuring.[18] A memorandum dated May 21, 2013, issued by Senators Levin and McCain in connection with the hearings, considered matters such

[17] The Information and documents on these hearings are available at https://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2.

[18] Senator John McCain, R-Ariz., in his opening statement at the 2013 PSI hearings on Apple Inc. (cited in the preceding footnote), stated: "As the shadow of sequestration encroaches on hard-working 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." See supra, note 10.

as transfer pricing, subpart F, and check-the-box, though it did not explore the ECI rules or their possible application to Apple.

The memorandum and exhibits released in connection with the hearings provided considerable internal intra-group information that is not included in consolidated financial statements or other publicly available information. From this information, Senator McCain noted:

> … The Subcommittee's investigation has uncovered a disturbing truth. Apple's three primary Irish entities hold 60 percent of the company's profits, but claim to be tax residents nowhere in the world. …

This 60% in Ireland was despite the fact that 65% of Apple's personnel were in the U.S. These personnel presumably included the bulk of the group's personnel who manage and conduct Apple's worldwide business, who manage and run on a day-to-day basis its online platforms, and who develop and manage the production of its products and market strategies.[19] By contrast, in some years, the PSI memorandum informs us that certain of the Irish companies that recorded the 60% of profits had zero employees.

Apple's effective tax rate for its fiscal year ended September 28, 2019 as reported in its most recent Form 10-K (page 45) was 15.9%, which reflects the lowered U.S. corporate tax rate of 21% following the TCJA.[20] The group's U.S. personnel count of 90,000[21] represents over 65% of its total employment of 137,000[22] and 90% of its long-lived assets are in the U.S. or China[23] rather than in Ireland. It seems doubtful that the current situation will be significantly different from what the PSI found during its May 2013 hearings. This of course suggests that there continues to be a significant divergence between where operations take place and where income is reported.

Prior to the Senate PSI and State Aid investigations, the company's consolidated financial statements and Form 10-K did not highlight or provide any specific suggestions that its structuring might be particularly aggressive. Yes, there were typical boiler-plate type disclosures of tax risk and the uncertainty of the outcome of tax audits. For example, the following is from the Risk Factors section in the September 29, 2012, Form 10-K (pages 19-20):

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[19] In regard to the location of most key personnel, the September 28, 2019, Form 10-K provides on page 12: "Much of the Company's future success depends on the continued availability and service of key personnel, including its Chief Executive Officer, executive team and other highly skilled employees. Experienced personnel in the technology industry are in high demand and competition for their talents is intense, especially *in Silicon Valley, where most of the Company's key personnel are located*." [Emphasis added.] This same disclosure is made in prior years' Form 10-Ks as well.

[20] It seems likely that this 15.9% is itself effectively overstated to some extent. For example, during the taxable period, the balance of uncertain tax positions rose by a substantial amount. This suggests some tax returns have been prepared taking positions that lowered cash tax liability while the book provision was prepared on the basis that these uncertain tax benefits would not be allowed. Only if relevant tax authorities raise and sustain assessments on these issues will these additional cash taxes ultimately be paid.

[21] See "Apple's US job footprint grows to 2.4 million", August 15, 2019, available at https://www.apple.com/newsroom/2019/08/apples-us-job-footprint-grows-to-two-point-four-million/.

[22] Apple Inc. Form 10-K, September 28, 2019, page 3.

[23] Apple Inc. Form 10-K, September 28, 2019, page 54, shows limited segment information. Regarding long-lived assets, of the total of $37,378 million, $24,711 million is in the U.S., $9,064 million is in China, and $3,603 million is in other countries.

> The Company is subject to taxes in the U.S. and numerous foreign jurisdictions. Current economic and political conditions make tax rates in any jurisdiction, including the U.S., subject to significant change. The Company's future effective tax rates could be affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, or changes in tax laws or their interpretation. The Company is also subject to the examination of its tax returns by the Internal Revenue Service and other tax authorities. The Company regularly assesses the likelihood of an adverse outcome resulting from these examinations to determine the adequacy of its provision for taxes. There can be no assurance as to the outcome of these examinations.

In the next year's Form 10-K (the year ended September 28, 2013, at page 19-20) following the May 21, 2013, Senate PSI hearings, this paragraph regarding tax risk was slightly expanded by references to the U.S. and Ireland. The following additional final sentence was also added:

> … If the Company's effective tax rates were to increase, particularly in the U.S. or Ireland, or if the ultimate determination of the Company's taxes owed is for an amount in excess of amounts previously accrued, the Company's operating results, cash flows, and financial condition could be adversely affected.

There seems to have been no suggestion in the financial statement disclosures of tax risk beyond the norm. Certainly, the initiation of the State Aid initiative by the European Commission could not have been predicted. However, with some reasonable understanding of the extent of the divergence between the locations where Apple conducted its operations and where it reported income, stakeholders would have been put on notice of potential risk. CbCR information would have provided this notice.

Interestingly, it took an economist to examine the details of some of Apple's reporting and bring Apple's tax situation more into the light. In brief, in two articles from mid-2011 and early 2012 prior to the 2013 PSI hearings, Martin Sullivan brought out some important issues.[24]

First, he examined the fact that only 30% of Apple's group profits were being reported in its U.S. tax returns despite the high proportion of its business that is conducted within the U.S.

> Apple does most of its research in the United States. Most of its key employees are in the United States. Fifty-four percent of its long-lived assets, 69 percent of its retail stores, and 39 percent of its sales are in the United States. A recent study funded by the Sloan Foundation and the National Science Foundation concluded: ''Apple continues to keep most of its product design, software development, product management, marketing and other high- wage functions in the U.S.'' (See Kenneth Kraemer, Greg Linden, and Jason Dedrick, ''Capturing Value in Global Networks: Apple's iPad and iPhone,'' July 2011.)
>
> Yet the company reports only 30 percent of its profits as being from the United States.…
>
> There will never be a precise answer as to where profits are created. But if the corporate tax is a tax on income, it is reasonable to place profits where value is created. In Apple's case, can there be any doubt that most of its value is created inside the United States? If

[24] Martin Sullivan, "Apple's High Effective Tax Rate Obscures Foreign Tax Benefits", 132 *Tax Notes* 0459 (August 1, 2011) and Martin Sullivan, "Apple Reports High Rate But Saves Billions on Taxes", 134 *Tax Notes* 0777 (February 13, 2012). Both of the quoted sections following this footnote are from the second of the two articles.

> we assume, conservatively, that 50 percent of profits should be U.S. sourced, then Apple's federal taxes would have been $2.4 billion more in 2011. Given the pivotal importance to Apple's success of product design and other functions performed in the United States, one could reasonably expect U.S. profits to be 70 percent of the worldwide total. In this case, payments to the U.S. government would have been $4.8 billion more in 2011.

Second, Mr. Sullivan noted Apple management's decision to treat more than half of the group's foreign earnings as not permanently reinvested. This had the effect of showing a relatively high effective tax rate compared with other MNCs that had aggressive tax structures and that treated most or all of their foreign earnings as being permanently reinvested. Because of the much lower cash tax payments, Apple's financial statements were showing increasing amounts of deferred tax liabilities for the U.S. taxes that would be due upon a future repatriation. Based on these management decisions, the effective tax rates reported by Apple from the time of Mr. Sullivan's analysis until the time that the TCJA became effective have been in a rough range of 24% to 26%. Mr. Sullivan commented:

> Apple reports a worldwide effective tax rate of 24.2 percent. … Apple would have a lower reported effective tax rate and higher profits if it recorded its tax expense the way most other companies do. … To lower their reported effective tax rates and boost their reported after-tax profits, most companies assume all of their unrepatriated foreign profits are permanently reinvested offshore. *If Apple asserted that all of its foreign earnings were permanently invested outside the United States, it would have booked an estimated $3.6 billion less in tax expense, and its effective tax rate would be 12.8 percent. ... When assessing Apple's tax situation relative to that of most other companies, this adjusted rate is probably more relevant than the reported 24.2 percent rate.* [Emphasis added.]

Following this quoted section, Mr. Sullivan speculates about why Apple chose this route that has the effect of obscuring its real tax position.[25] While his speculations are interesting, they are not relevant to this letter. Rather, what is relevant is that CbCR reporting that includes both current tax payments and accrued taxes for each country (such as is already required within Schedule A of IRS Form 8975—Country-by-Country Report) would make clear for stakeholders the existence of, and the extent of, any divergence between relative profits and taxes, on the one hand, and employees and tangible assets on the other.

This discussion concerning Apple is just one example. Undoubtedly, there are many many more. Disclosures that show CbCR information are sorely needed. And because this information is already being prepared for annual tax filings with the IRS under the BEPS process, there should be no significant cost to a CbCR disclosure requirement in U.S. financial reports.

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[25] In brief, Mr. Sullivan's speculations run along two lines as follows:
"Perhaps because it is breaking all records for profitability now, it is saving some profits for less fortunate times in the future. As the Joint Committee on Taxation recently wrote: 'If the company accrues the tax expense in the year the profits are earned, it may later decide that those funds will not be repatriated after all. At that later time it may then reverse the tax expense and shift financial statement income from the prior period into the current period.' [Citation omitted.]
"An alternative explanation is that perhaps Apple — with its young, socioeconomically elite customer base — does not want the negative publicity that a low effective tax rate could generate with groups like Citizens for Tax Justice and US Uncut."

Before leaving the subject of the need for CbCR information in financial accounts, it is necessary to add that any requirement for inclusion of this information should include the requirement that the information disclosed must reconcile to the books and records of the group members from which the consolidated financial statements have been prepared. While it is to be expected that most MNCs will already have internal controls that would require such reconciliations for information provided in tax filings (including Form IRS Form 8975 and its accompanying Schedule A), it would be beneficial to make this clear in future guidance that FASB provides.

Need for Guidance on Location

New paragraphs 740-10-50-10A, 74-10-50-10B, and 74-10-50-22 in the March 25, 2019, Proposed Accounting Standards Update (Revised) call for the disclosure of:

> (i) domestic and foreign income or loss from continuing operations before intra-entity eliminations and before income tax expense,
>
> (ii) federal or national, state, and foreign income tax expense (or benefit) from continuing operations (with the proviso that any taxes imposed by the jurisdiction of domicile on foreign earnings will be treated as taxes imposed by the jurisdiction of domicile), and
>
> (iiI) federal or national, state, and foreign income tax paid (with a similar proviso that any taxes paid to the jurisdiction of domicile on foreign earnings will be treated as taxes paid to the jurisdiction of domicile).

FASB is to be commended for including this as a requirement in financial statements.

Regarding new paragraph 74-10-50-10A, there appears to be no guidance in the Update for determining whether income or loss is domestic or foreign. Guidance is sorely needed.

While I have made no survey of how public business entities determine location for segmentation disclosure of group revenues, I understand that some such entities use the location of the customer to determine location.[26] Such a basis is appropriate for business segmentation purposes since an important goal of this geographic disclosure is to "provide information [to users of financial statements] that is more useful in assessing the impact of concentrations of risk."[27]

Risk from the concentration of revenues is not the same as tax risk. An MNC through its corporate structuring and its internal asset transfers and intercompany agreements effectively apportions its income or loss from continuing operations to the various countries within which it operates. Where that apportionment reasonably reflects the value that is represented by the actual operations in each country of the MNC through personnel and assets, then there should be little risk from potential transfer pricing and other tax authority adjustments that would increase the taxable income in a particular country. On the other hand, when there is a significant divergence,

[26] For example, for Apple, its Segment Information and Geographic Data (Note 11 in the September 28, 2019, Form 10-K on page 53) provides, in part, the following concerning the calculation of segment information:

> … Net sales for geographic segments are generally *based on the location of customers and sales through the Company's retail stores* located in those geographic locations. Operating income for each segment includes net sales to third parties, related cost of sales and operating expenses directly attributable to the segment. … [Emphasis added.]

[27] Paragraph 105 of Appendix A (Background Information and Basis for Conclusions) of FASB Statement 131.

then there may well be significant risk that must be communicated to stakeholders within the financial statement disclosures.

Full country-by-country information for this new paragraph 740-10-50-10A disclosure of income or loss from continuing operations would be significantly better than the more limited domestic/foreign information that will be required. However, this more limited domestic/foreign information will still be important and is a significant improvement in giving stakeholders a greater appreciation of tax risk with respect to the country of domicile.

To make this new disclosure concerning income or loss from continuing operations meaningful to stakeholders, there must be guidance provided that requires location to be determined primarily on the basis of the location of the tangible assets and personnel that generate that income or loss.

However, there are also currently on-going developments in the G20/OECD effort to obtain international consensus on new international tax rules that would provide market countries some limited ability to tax revenues generated from within their borders.[28] Considering that these developments are expected to be finalized by the end of 2020, guidance could provide that the paragraph 740-10-50-10A location could be partially assigned to the country of the customer when that country does impose tax using a factor such as local sales that is independent of the MNC's assets and personnel that might also be within that country's borders.

There is a further reason for focusing primarily on the location of personnel and tangible assets that generate the income or loss from continuing operations.

Paragraph 810-10-10-1 reads, in part:

> The purpose of consolidated financial statements is to present, primarily for the benefit of the owners and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries *as if the consolidated group were a single economic entity*. [Emphasis added.]

As a single economic entity, purely internal matters including the corporate structure and internal asset transfers and intercompany agreements are ignored. What is left are the tangible assets and the actual personnel performing their functions in various locations around the world. Intangible assets are owned by the single economic entity as a whole and not as the legal property of any portion of the entity.

Again, using Apple as a simple example, there are many activities that Apple as a single economic entity has conducted around the world to create its successful products and services. As was covered above, a majority of the group's profits have been recorded within Irish subsidiaries and have escaped *current* U.S. taxation (at least prior to the partial taxation that now occurs under the TCJA GILTI provisions).[29] Despite this recording of so much profits in Irish subsidiaries, Apple has made representations that its activities in Ireland are routine and of

[28] See the new taxing right (Amount A) discussed in "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy", released by the OECD on January 31, 2020, at https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

[29] The TCJA's a one-time transition tax on accumulated foreign earnings does not change this discussion or the principles at issue.

presumably little value in comparison to the activities occurring elsewhere in the world. The following representations were made in the December 19, 2016, appeal[30] by two of Apple's Irish subsidiaries of the European Commission's decision concerning State Aid.

> The Commission made fundamental errors by failing to recognise that the applicants' profit-driving activities, in particular the development and commercialisation of intellectual property ('Apple IP'), were controlled and managed in the United States. The profits from those activities were attributable to the United States, not Ireland. The Commission wrongly considered only the minutes of the applicants' board meetings and ignored all other evidence of activities.
>
> The Commission failed to recognise that the Irish branches carried out only routine functions and were not involved in the development and commercialisation of Apple IP which drove profits.
>
> The Commission presumed that all of the applicants' critical profit-making activities were attributable to the Irish branches without properly assessing the evidence, including extensive expert evidence showing that the profits were not attributable to activities in Ireland.

Some of these activities (presumably mostly marketing and sales), of course, occurred in foreign countries other than Ireland. There were also presumably some R&D activities conducted outside the U.S. as well as production functions conducted in China and elsewhere outside the U.S. where Apple personnel supported, liaised, or otherwise worked with major Apple component suppliers and contract manufacturers. However, it is also clear that significant R&D, production, marketing, sales, and other management and day-to-day business and support activities occurred within the U.S.[31]

Considering the above, when Apple is viewed as a single economic entity within consolidated financial statements and the location of income or loss from continuing operations is to be determined, that determination must take into account the location of all relevant activities and tangible assets. As such, to the extent that personnel and assets are outside the U.S. generating the income or loss, then that portion would foreign. And to the extent that personnel and assets are inside the U.S. generating the income or loss, then that income would be domestic.

Paragraph 740-10-50-10A disclosure must reflect this reality that MNCs often generate their income or loss from within both their country of domicile and foreign countries. As such, guidance for applying paragraph 740-10-50-10A is critical to assure that such MNCs reflect this multiple-country generation of income or loss in their tax footnote disclosure. Only in this way can stakeholders identify and assess potential risks.

Several points should be made regarding future guidance on location.

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[30] Available at http://eur-lex.europa.eu/legal-content/en/TXT/PDF/?uri=uriserv%3AOJ.C_.2017.053.01.0037.01.ENG.

[31] This is consistent with Martin Sullivan's comments in his two articles cited above. His February 13, 2012, article, quoted from a study that concluded: "Apple continues to keep most of its product design, software development, product management, marketing and other high- wage functions in the U.S."

First, personnel, assets, and other factors[32] if any when applied to determine location of income or loss from continuing operations must of course be appropriately weighted. Given the importance of the contribution of personnel both to the development of intangible assets and the actual management and conduct of any business, it seems appropriate to suggest that the personnel factor be given a greater weighting in comparison to other factors. Thus, for example, if there are three factors (e.g., personnel, assets, and revenue), the personnel factor could be given twice the weighting of the other two factors Thus, the weighting would be 50% for personnel, 25% for assets, and 25% for revenue. If there were only two factors (e.g. personnel and assets), it could be two-thirds for personnel and one-third for assets.

Second, some personnel and tangible assets are involved in R&D and other functions that create or enhance intangible property. Other personnel and tangible assets are involved in day-to-day business and commercial functions. With this distinction in mind, several economists working in transfer pricing have considered intangibles and human capital.

> The idea that intangible assets are the main creators of value rather than people has ruled supreme for years in the transfer pricing discipline. Although that idea is superficially true, *economists are in general agreement that intangibles themselves are the product of cumulative investments in human capital*. Irving H. Plotkin and Dan Axelsen provide a thorough synopsis of the economic literature on the role of intangibles in economic growth and the importance of human capital (including education, creative talent, experience, and decision-making ability) in developing intangibles. [Cf. Plotkin and Axelsen, "The Three-Factor Formula vs. the Sources of Income in the New and Weightless Economy," *Tax Mgmt. Int'l J.* (Jan. 2013).] The intangibles-centric view often distracted transfer pricing practitioners from the importance of the work entailed to develop, enhance, maintain, protect, and exploit intangible assets (the so-called DEMPE functions) and the location of that work, and (until the BEPS project) it led them to overemphasize the tax jurisdiction of legal ownership of intangibles.[33] [Footnotes omitted.]

The above point saying "intangibles themselves are the product of cumulative investments in human capital" leads to an important point for guidance concerning personnel and the location of income or loss from continuing operations. There has been considerable attention in recent years on the DEMPE functions, which were mentioned earlier in this letter. Usually in discussion, they are all lumped together with no consideration of their varying natures. Their natures, though, differ importantly when thinking about their relevance to this issue of where income or loss is located. In particular, development and enhancement functions can create intangible assets. Maintenance, protection, and exploitation, on the other hand, are involved in conducting a business that uses the developed and enhanced intangible assets.

Considering this distinction as well as Stepanyan and Felgran's point about "cumulative investments in human capital", it is appropriate in location of income or loss guidance that the development and enhancement personnel costs (including any relevant tangible asset costs) be determined on a cumulative basis or perhaps on a formula basis that includes, say, the current

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[32] For example, mention was made earlier about the current G20/OECD effort to allow market countries some ability to tax income from sales or services generated within their borders.

[33] From Ara Stepanyan and Steven D. Felgran, "People Functions Redux: A New Approach to Profit-Splitting Factors", *Tax Notes Federal*, September 23, 2019, P. 2035.

and prior two years or maybe the current year plus 75% of the immediately preceding year, 50% of the second preceding year, 25% of the third preceding year. There's no right or wrong answer on the approach or formula to use. However, the concept is important that a cumulative measurement of relative development and enhancement costs in each country is the best measure for the location of income or loss because it truly accounts for the intangible assets created and avoids the terrible subjectivity of trying to value intangibles and determine their location.

This point about cumulative costs for development and enhancement costs might also apply to personnel (and any relevant asset costs) involved in marketing and sales activities that truly develop marketing intangibles, in contrast to such activities that perform routine marketing and sales on a day-to-day basis.

In contrast to the above costs that develop intangibles and call for some cumulative accounting in determining location of income or loss, normal day-to-day business expenses including the DEMPE functions of maintenance, protection, and exploitation costs are all period costs that should not be cumulated.

The above comments about intangibles involve self-developed intangibles. If there have been major purchases of intangibles from unrelated persons, then guidance should be provided concerning them. On the one hand, since an MNC as a single economic entity does not economically own the intangibles in any one location, there is logic to ignore such purchased intangibles in the determination of location of income or loss from continuing operations. If, however, the Board decides that such purchased intangibles should affect the determination of location, then they could be included in an assets factor that also includes tangible assets. As the value of such intangibles should decline with the passage of time and further development and enhancement, the same type of formula basis as suggested above could be used to reduce the value in future years' location computations. As for location, it seems that the location of personnel involved in development and enhancement will of course determine the location of further development and enhancement of any purchased intangibles. The purchased intangibles themselves, though, could be treated as located at the location (or locations) of the personnel who made the commercial/investment decision to acquire the assets.

Disclosures Concerning Unrecognized Tax Benefits (UTBs)

The existence of any UTBs indicates that there is a 50% or less chance of sustained realization in the event of a tax authority review on a full-disclosure basis. Given this 50% or less situation, stakeholders would be very interested in knowing whether any reductions in UTBs arise from, for example:

- Active tax authority agreement,
- Sustaining the position through the judicial process,
- Increase in percentage above 50% due to a new development such as a tax law change, an administrative ruling, or a new judicial decision that supports the public business entity's position,
- The lapse of an applicable statute of limitations,
- Payment of a portion or all of the UTB.

Information regarding the reasons for reductions would provide critical evidence to stakeholders of management's ethical judgments and its propensity for taking risky or questionable tax positions based on an audit-lottery mentality.

For stated reasons, the Board has decided not to include a requirement in this proposed Update to separately disclose cash settlements and noncash settlements of unrecognized tax benefits. I suggest that a requirement should be initiated to disclose the reasons for reductions in UTBs. This would provide information important to stakeholders that would be simple for public business entities to provide. In short, it would explain the consequences of an entity's tax strategies.

*   *   *   *

If you have any questions concerning the above, I would be pleased to communicate either by email or phone.

Very truly yours,

Jeffery M. Kadet

Attachment

Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, ''Profit Shifting: Effectively Connected Income and Financial Statement Risks'', 221 J. Acct. 48 (Feb. 2016), soft copy available at http://ssrn.com/abstract=2728157.