7-4-2016

Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 2

Jeffrey M. Kadet
University of Washington School of Law

David Koontz

taxnotes®

Volume 152, Number 1 ■ July 4, 2016

Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 2

By Jeffery M. Kadet and David L. Koontz

Reprinted from *Tax Notes*, July 4, 2016, p. 85

Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 2

by Jeffery M. Kadet and David L. Koontz

Jeffery M. Kadet

David L. Koontz

Jeffery M. Kadet was in private practice for over 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle. David L. Koontz is a retired CPA who, as a tax partner in a major accounting firm, spent 25 years working in offices in the United States and Asia. He was involved with international transactions, including raising capital from multiple sources and using that capital in public and private companies worldwide.

Lawmakers from both sides of the aisle campaign against tax "loopholes" that benefit large corporate taxpayers but then actively lobby for benefits for their favored industries and corporate friends. The outcome is a complicated body of tax law containing special provisions that are seen as benefits by some and loopholes by others. This potent mixture of worldwide taxation, deferral, high tax rates, complicated rules, and special benefits is the fodder that has given rise to myriad sophisticated and inscrutable tax avoidance structures. With the complexity of the tax law encouraging profit-shifting strategies, how can nontax expert management and board members judge the propriety of the structures for which they're responsible?

This is a two-part report; Part 1 appeared in the June 27 issue of *Tax Notes*. In the first part, Kadet and Koontz set out an ethical benchmark that multinational corporations can use to objectively test the propriety of their profit-shifting structures. This second part suggests several steps that should be considered by multinational boards, professional tax advisers, Congress, Treasury, and the IRS to improve tax strategies, corporate governance, and the equitable collection of taxes.

Table of Contents

IV. **Systemic Concerns and Practical Suggestions** 85
A. Introductory Comments 85
B. Board of Directors and Management 86
C. Professional Firms 89
D. Statutory and Regulatory Improvements . 92
V. **Conclusion** 95

IV. Systemic Concerns and Practical Suggestions

A. Introductory Comments

Several systemic issues and developments over past decades have strongly encouraged the aggressive profit-shifting structures that motivated the OECD base erosion and profit-shifting project.[54] Of these many issues, several should be of interest to MNCs, professional firms, governments, and other stakeholders:

- Conflict of Interest — Executive Management

Often, an MNC's CEO and senior management receive a material portion of their remuneration from equity-based compensation plans with the obvious result that they have a personal financial interest in the MNC's share price. These individuals are personally motivated to adopt tax structures that will minimize the MNC's effective tax rate to maximize earnings and share price in the short term. This creates an inherent conflict of interest.

[54]*See* Jeffery M. Kadet, "BEPS: A Primer on Where It Came From and Where It's Going," *Tax Notes*, Feb. 15, 2016, p. 793.

Any IRS audit and increased tax expense will likely occur years in the future, perhaps after the CEO and other management personnel have moved on to other endeavors.[55]

- Outside Advisers — Large Billings for Advice and Implementation

Whether it is a law firm, accounting firm, investment bank, or other adviser that sells or implements a profit-shifting strategy for an MNC, the project may mean big billings, sometimes with a value component.

A major ''public'' example is work that PwC and McDermott Will & Emery performed for Caterpillar in the implementation of its Swiss tax strategy. The Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI) majority staff report issued in connection with the 2014 PSI hearings on Caterpillar's tax strategy stated: ''From 1998 to 2004, Caterpillar paid PwC over $80 million in tax consulting fees, including over $55 million related to the development and implementation of the Swiss tax strategy.''[56]

James S. Eustice, a respected academic and noted tax lawyer, commented in 2002:

> Another contributing factor, closely related to taxpayer avarice, is the stunning profitability of these corporate shelter transactions for their promoters. This feature is reminiscent of the 1960's and 1970's when former stockbrokers realized they could do much better financially by peddling tax shelters than by selling stocks and bonds. Promoter profitability is certainly a major impetus driving the spread of corporate tax shelters. . . . Once these transactions begin to go retail — and we are perilously close to that point now, if not past it — what may be merely a serious problem becomes a critical one.[57]

Congress and regulators would do well to keep these systemic issues in mind as they consider new legislation or regulatory approaches to curb abuses and conflict of interest concerns. Importantly, these matters also merit immediate attention from other parties, as set out below.

B. Board of Directors and Management

The board of directors of an MNC bears a heavy responsibility in carrying out its fiduciary duty to ensure that the group is well managed and follows sound financial practices. Therefore, boards should consider:

- Overall Policy — Tax Matters

It is clear that many MNCs use a tax minimization approach, under which an MNC may take actions to implement organizational changes solely to achieve tax savings. Often, the changes may be minimal, with the intention of not significantly altering an existing business model. In contrast, a recent study has identified some companies that use a ''sustainability'' approach, under which a company's tax strategies and structures align with operational choices and reflect company or industry characteristics.[58] In short, this type of tax structuring will follow operational needs rather than taking on a life of its own.

The point of raising this issue of minimization versus sustainability and the effects on shareholder value, level of risk facing the MNC, and public disclosure[59] is that each board of directors should consider these competing approaches and make a conscious decision on how its MNC should conduct itself regarding tax matters.

[55]Thomas R. Kubick and G. Brandon Lockhart studied the relationship between the potential for a better CEO position in the future with current behavior on corporate tax aggressiveness. ''Building on recent theory, we find strong and robust evidence that external labor market incentives motivate CEOs to adopt more aggressive tax policies in order to improve firm performance and their own labor market value.'' *See* Kubick and Lockhart, ''Do External Labor Market Incentives Motivate CEOs to Adopt More Aggressive Corporate Tax Reporting Preferences?'' 36 *J. Corp. Fin*. 255 (2016).

[56]*See* PSI, ''Caterpillar's Offshore Tax Strategy,'' at 46 (Apr. 1, 2014). *See also Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), which involved an $800,000 fee paid to PwC for a tax opinion. The Tax Court commented: ''PwC crossed over the line from trusted adviser for prior accounting purposes to advocate for a position with no authority that was based on an opinion with a high price tag — $800,000.'' *Id.* at 220. Later, the court added: ''If we were to bless the closeness of the relationship, we would be providing carte blanche to promoters to provide a tax opinion as part and parcel of a promotion. Independence of advisers is sacrosanct to good faith reliance.'' *Id.* at 221.

[57]Eustice, ''Abusive Corporate Tax Shelters: Old 'Brine' in New Bottles,'' 55 *Tax L. Rev*. 135, 146 (Winter 2002).

[58]Stevanie S. Neuman, ''Tax Strategies: It's Not Just About Minimization'' (Feb. 19, 2016).

[59]One apparent effect of a tax minimization approach may be a reduction in some disclosures. *See* Jeffrey Gramlich and Janie Whiteaker-Poe, ''Disappearing Subsidiaries: The Cases of Google and Oracle'' (Mar. 6, 2013), in which the authors examine the actions by Google and Oracle to reduce by 98 percent and 99 percent, respectively, the subsidiaries disclosed in Exhibit 21 of their 2010 Forms 10-K compared with those disclosed in their 2009 Forms 10-K. The authors comment: ''If Google and Oracle are disclosing less subsidiary information in an effort to frustrate tax authorities' ability to detect aggressive tax strategies, this can also decrease the ability of shareholders to assess the benefits and potential risks derived from tax savings. Therefore, providing a comprehensive list of significant subsidiaries should benefit investors.''

- CEO/Management Conflict of Interest Issue

Do the group's equity-based compensation plans measure performance either directly or indirectly on an after-tax basis such as share price? If so, boards should consider plans that measure performance in some pretax manner. This would encourage the management group to consider tax policy and decisions based solely on what is best for the MNC on a long-term basis and guard against being influenced by personal financial considerations.[60]

- Standards of Tax Reporting

An MNC's board should ensure that the organization has a clear corporate policy that requires its tax conduct to be consistent with standards of good corporate governance, which would mandate that all tax strategies and structures pass a high bar for technical accuracy. For example, the policy should require that any tax transaction or structure meet the economic substance requirements of section 7701(o).[61] Ideally, the standards should go beyond the minimum standards set by the American Bar Association, the American Institute of CPAs, and the government through Circular 230. Those higher standards should require that all significant tax positions pass the ''more likely than not'' standard, meaning that upon an IRS examination, it would be more likely than not that the position adopted by the MNC would prevail. This standard already exists and is defined in the tax law for some transactions and in financial statement accounting rules.[62] This should also make the attestation and other requirements of the Sarbanes-Oxley Act (P.L. 107-204) more meaningful.

Finally, the policy should require that senior management sign off on any tax planning with potential tax savings that is material or carries reputational risk. Material tax strategies should not be implemented until a presentation is made to the board for its approval or rejection.[63]

- Board-Level Due Diligence — Tax Matters

For tax issues of sufficient gravity, boards should require that a second opinion be obtained from a disinterested law firm, accounting firm, or other qualified adviser. A disinterested professional is best able to review all facts and risks and render a balanced view. Relying solely on an opinion letter from a firm or adviser that stands to gain from the execution of a plan or is seeking additional work is not good corporate governance. Good governance also suggests that for major tax matters, independent board directors, rather than an MNC's management, should select the disinterested firm or adviser.

In some cases, opinions from advisers involved in the planning or implementation of a strategy cannot be used by a taxpayer to support its reasonable belief concerning a tax position, which is required for the reasonable cause exception to apply to avoid specific tax penalties.[64]

To emphasize the need for due diligence at the board level over tax matters, Caterpillar is again a convenient example. As reported in the PSI hearing documents, Caterpillar made no changes to the conduct of its U.S.-managed parts business, yet it was able to transfer the

---

[60]Why MNC leaders and their professional advisers practice profit shifting on such a wide scale is perhaps best understood by borrowing a page from the Willie Sutton playbook: Taxes are where the money is. With this in mind, one should note the perhaps understated comment in the March 21, 2016, announcement made by Valeant Pharmaceutical International: ''The improper conduct of the company's former Chief Financial Officer and former Corporate Controller, which resulted in the provision of incorrect information to the Committee and the company's auditors, contributed to the misstatement of results. In addition, as part of this assessment of internal control over financial reporting, the company has determined that the tone at the top of the organization and the performance-based environment at the company, where challenging targets were set and achieving those targets was a key performance expectation, may have been contributing factors resulting in the company's improper revenue recognition.''

[61]A transaction must change meaningfully (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer must have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

[62]*See* reg. section 1.6662-4(f), Financial Accounting Standards Board Interpretation No. 48, ''Accounting for Uncertainty in Income Taxes,'' and FASB Codification Topic 740-10-25-5. *See* **(Footnote continued in next column.)** *also* Bret Wells, ''Adopting the More Likely Than Not Standard for Tax Returns,'' *Tax Notes*, Apr. 26, 2010, p. 451; and Wells, ''Voluntary Compliance: 'This Return Might Be Correct But Probably Isn't,''' 29 *Va. Tax Rev*. 645 (2010).

[63]If there are any complaints from shareholders that directors have a legal duty to minimize corporate taxation, see Daniel Hemel, ''A 'Duty' to Minimize Taxes?'' The University of Chicago Law School Faculty Blog (Dec. 22, 2015). *See also* the cases Hemel cites, including *Freedman v. Adams*, 2012 Del. Ch. LEXIS 74 (2012); and *Seinfeld v. Slager*, 2012 Del. Ch. LEXIS 139 (2012). The courts in those two cases found no fiduciary duty to minimize taxes.

[64]For profit-shifting structures that qualify as reportable transactions, any material adviser that participated in the planning or implementation of the structure would be considered a disqualified tax adviser under section 6664(d)(4)(B)(ii). An opinion by a disqualified tax adviser cannot contribute to the reasonable belief of a taxpayer, which is required to avoid penalties under section 6662A.

bulk of the profits from that business from the United States to Switzerland. The PSI's majority staff report disclosed:

> Caterpillar accomplished that profit shift without making any real changes in its business operations. It continued to manage and lead the parts business from the United States.
>
> . . .
>
> Despite the fact that its parts business is managed and led primarily from the United States, Caterpillar used a series of complex transactions to designate a new Swiss affiliate called CSARL as its "global parts purchaser," and license CSARL to sell Caterpillar third party manufactured parts to Caterpillar's non-U.S. dealers. Caterpillar also signed a servicing agreement with CSARL in which it agreed to keep performing the core functions supporting the non-U.S. parts sales, including overseeing the U.S. parts supplier network, forecasting parts demand, managing the company's worldwide parts inventory, storing the parts, and shipping them from the United States. Caterpillar agreed to perform those functions in exchange for a service fee equal to its costs plus 5 percent.[65]

Certainly in hindsight, Caterpillar's transfer through contractual steps of the bulk of its parts business profits to Switzerland should have been seen as too good to be true. Boards need to receive disinterested advice and opinions to gain a full understanding of the potential benefits and risks before approving the implementation of major tax strategies.

- Not Placing Audit Firm in a Potential Conflict Position

Boards of directors and audit committees should be particularly sensitive to approving consulting work on tax-motivated structures provided by the tax department of the MNC's audit firm, since doing so may place the audit firm in a position of conflict when it must judge the work of its tax group. We suggest that corporate governance best practices should draw a relatively bright line by limiting an audit firm's tax work to compliance.

- Consideration of Fee Arrangements

Boards should fully understand any tax engagement that may obligate the company to pay a substantial fee determined on a "value" basis rather than on an hourly or other time-based pricing mechanism. Tax planning and advisory services are regularly provided in response to real business and investment transactions being contemplated. An adviser's guidance and recommendations are based on the specific facts and circumstances of the taxpayer, and a time basis for measuring fees is typically used. In those cases, a tax adviser is responding to the business needs of the taxpayer; the adviser is not "selling" a tax-saving technique or product to the taxpayer.

When a tax-saving technique or product is recommended to a taxpayer independent of any business or investment transaction, there should be a heightened level of concern regarding the benefits and risks. Further, as noted earlier, if the board or management wishes to pursue any specific technique or product, a second opinion from a disinterested professional should be obtained.[66]

- Encouraging Internal Whistleblowers

An important point that boards and managements should not forget is that concerned employees may question profit-shifting structures that they in good faith believe might reflect questionable judgment and have negative consequences for an MNC. The complaint by a former Caterpillar employee filed in 2009

---

[65]PSI, *supra* note 56, at 1-2 (majority staff comments).

[66]*See* Frederic G. Corneel, "Guidelines to Tax Practice Third," 57 *Tax Law*. 181, 192-193 (2003). Corneel approached this issue from the perspective of the professional firm:

> Also related to the desire to build profitability is the marketing of products developed by the firm, particularly where our services are to be performed on a "value billing" basis. There is nothing wrong, as part of our tax planning services, to promote appropriate tax strategies in a manner not so different from investment bankers. As a thoughtful friend writes, "In multi-office, multinational, multi-disciplinary organizations, it is necessary to capture the intellectual capital of the firm in training materials and internal databases to enhance consistency, risk management and quality assurance as well as to extend quality services to the very large and diverse client base." But the emphasis must be on the word appropriate. Is the approach consistent with respect for the tax system or does it rely on a strained interpretation of the tax law or doubtful valuations? Further, is the particular approach suitable to the client and its needs? The promotion of "products" we have developed clearly makes more urgent the need to strike a proper balance between what is best for the client and what is best for our firm. Referring clients to an advisor that does not share our motivation may at times be the best way of protecting both the client and the future business of our firm which in the long run depends upon matching the service that we provide for our client with the client's needs.

led directly to PSI's 2014 investigation of Caterpillar's Swiss tax strategy.[67] In a recently filed case, a fired employee alleges that Viacom Inc. transferred or planned to transfer licensing rights for *Teenage Mutant Ninja Turtles* (TMNT) to a Dutch subsidiary. In connection with those rights, the complaint states regarding 2009 or 2010:

> TMNT was owned by an entity in the Netherlands, but all of the business concerning those rights took place in New York. New York personnel made the licensing decisions, and the licensing contracts were negotiated by attorneys in New York and were subject to New York law.[68]

The complaint noted that a part of the planning that was apparently reinstituted in 2013 was to have an employee in the Netherlands who would be signing the licensing contracts and purporting to be amending them ''to make it appear that they were being handled abroad.''[69]

The board and management must create internal communication systems that encourage all employees to voice their concerns without fear of reprisal.

- Adequacy of Intercompany Accounting

Deloitte, one of the major international audit firms, made a relevant observation in a recent marketing brochure:

> Today's organizations are far more complex than they were a mere decade or so ago. They also face increased competition on the one hand and greater regulatory scrutiny on the other. Many companies have significantly expanded their global footprints, creating multinational value chains that generate an enormous volume of intercompany transactions. Operating in multiple countries also introduces the need for compliance with country-specific regulations and tax policies.[70]

As the brochure makes clear, Deloitte's experience is that MNC intercompany accounting needs have often been downplayed and neglected because of an ''everything nets out'' mentality. However, profit-shifting structures rely heavily on the need for additional intercompany transactions that only increase systems costs, administrative burdens, and the risks associated with the profit-shifting structure. This aspect must be an important part of any judgment that a board or management makes when considering adopting or maintaining a tax-motivated structure.[71]

- Unwinding Existing Profit-Shifting Structures

Some boards of directors and managements, after careful review, may conclude that their MNC is either a strong candidate for ECI taxation or is, in fact, required to file tax returns and pay taxes at rates exceeding 35 percent. On either count, they should consider not only what ECI to report for the current and prior years and what disclosures and accruals of tax liability to include in their financial statements, but also whether and how to change or unwind the profit-shifting structures to ensure that future earnings are subject to no more than the maximum 35 percent U.S. corporate tax rate.[72]

C. Professional Firms

Profit-shifting strategies and structures are not formulated on the shop floor or in the laboratory. Rather, they are usually created and designed by an MNC's in-house legal, accounting, and tax personnel and outside advisers, including professional law and accounting firms. Sometimes there is top-down direction from an MNC's CEO, senior management, or board of directors. Most individuals with the expertise to create and implement profit-shifting structures are likely found in the large and respected international law and accounting firms, and often these firms, as well as other professionals, take the initiative to recommend new tax strategies and products to their MNC clients.

Professional firms and other advisers that promote and help their clients implement potentially

[67]*See Schlicksup v. Caterpillar Inc.*, No. 09-1208 (C.D. Ill. filed 2009).

[68]Complaint at para. 14, *Williams v. Viacom International Media Networks Inc.*, No. 1:16-cv-00029 (S.D.N.Y. filed Jan. 5, 2016).

[69]*Id.* at para. 30. This alleged situation, in which U.S.-based personnel conduct the business of a controlled foreign corporation, presents a classic case that may result in the CFC being subjected to effectively connected income taxation at a greater than 35 percent tax rate.

[70]Deloitte, ''Cleaning Up the Mess Under the Bed: Why Intercompany Accounting Is Increasing Corporate Risk,'' at 3 (Jan. 2016).

[71]*See* PSI, *supra* note 56, at 56*ff*, discussing Caterpillar's internal tax department's creation of a ''virtual parts inventory.'' This inventory, which was created with the help of the company's accounting and legal advisers, was used not for any operational purpose but solely to support the profit-shifting structure.

[72]For a discussion of this issue and other relevant suggestions, see Thomas J. Kelley, David L. Koontz, and Kadet, ''Profit Shifting: Effectively Connected Income and Financial Statement Risks,'' 221 *J. Acct*. 48 (Feb. 2016).

problematic tax structures should review the tax risks of those structures using the benchmark proposed in the first part of this report. That would allow professionals to be proactive in helping clients understand the risk and, if warranted, take appropriate actions to either change the structures or unwind them.

An outside auditor is in a particularly sensitive and conflicted position in issuing audit opinions on financial statements of an MNC that has implemented profit-shifting strategies based on the advice, guidance, and opinions of that audit firm's tax consulting group. This problem was addressed earlier regarding issues of concern to boards of directors. If an audit firm identifies a client with a high-risk tax profile, it should consider advising the client to retain other tax advisers. Alternatively, the audit firm might question whether it wishes to continue as the client's auditor, in which case it would advise the client to retain another audit firm.

Perhaps more importantly, all parties should be aware that rules mandated by the Public Company Accounting Oversight Board limit an auditor's ability to provide planning services for aggressive tax position transactions to its audit clients. Specifically the PCAOB's Rule 3522 states that an auditor will forfeit its independence with respect to a client if the audit firm or any affiliate provides services in connection with an aggressive tax position transaction that does not meet the "more likely than not" standard. Presumably all audit firms have amended their procedures to comply with Rule 3522 and have communicated the consequences of this rule to the management and audit committees of their clients. Given the potential consequences of losing their independence because of PCAOB Rule 3522, audit firms must have in place procedures to review all advice provided to their clients not only for prospective aggressive tax transactions, but even advice given for past transactions, especially where the IRS later classifies those transactions as "listed" transactions.[73]

[73]*See* PCAOB Rule 3522 concerning "Tax Transactions." This rule controls whether a registered public accounting firm is independent of its audit client. There have been recent actions by the IRS to attack some profit-shifting structures (see Part 1, note 14). In light of these developments, some tax planning and/or structures participated in by an MNC's audit firm that were previously believed to meet the "more likely than not" standard required by Rule 3522 might, upon being re-analyzed, not meet that standard. For example, this may be the case where the facts strongly support ECI taxation, as set forth in Part 1 of this report. Such a finding could have significant consequences to both the MNC and its auditor. See PCAOB Staff Questions and Answers, Q&A 4, "Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees," Apr. 3, 2007.

The above suggests several additional points:

- Senior-Level Review

If not already a part of their normal internal procedures, professional firms should consider requiring a senior-level review before the delivery to a client of all high-risk projects that involve profit-shifting structures. And when those procedures are already in place, professional firms should periodically review them to ensure that the risks to the firm and its clients are fully understood, documented, and communicated to appropriate client personnel.

This review should be conducted by senior firm members who are independent of the client engagement. While this review should confirm the technical tax conclusions reached, it should also include an in-depth consideration of (1) whether the actions recommended could be harmful to the client's and the firm's reputations; (2) whether the work product fully complies with the firm's internal professional standards; and (3) whether the advice is within the firm's appetite for undertaking risk.

A 1980 article from George Cooper, meant to illustrate the dynamics of giving tax avoidance advice, provides the appropriate flavor for a senior review, despite its dated prose:

> I used to agonize over an obscure provision until I thought I knew the right interpretation. And I would advise the client accordingly, encouraging him to conduct his affairs so that he would fare well under what I detected to be the probable legal result, and steering him away from schemes, no matter how alluring their song, that depended on an unsound interpretation. More than that, I thought there was some mix in my duty. It was not unalloyed avoidance-seeking, but had at least a measure of allegiance to the fisc and to higher principle. Some things were wrong, even if they worked.
>
> . . .
>
> We have to practice law in the world as it is, and if my clients need to swim in already polluted waters I will help them; but I draw the line at adding to the pollution, even if it is technically legal and ethical [under the minimum ABA standards].
>
> . . .
>
> Is this attitude inconsistent with the interests of my clients? I think not. . . . *Clients usually are "honest innocents" when it*

> *comes to tax manipulations, and the tax advisor "bears a heavy responsibility here, for his standards may become the guiding standards for his client."* . . . It is facile to say that decisions in a technical field such as this are made by the client, when so much depends on how we present the options and what we, as experts, recommend. *We have great power to encourage or to discourage transactions*, and I read Canon 9 as imploring us to discourage actions that undermine the basic structure of the tax law. There is a great temptation to tout clever dodges, because it makes us look smart, but we serve the law, ourselves, and even our clients better if we accentuate the negative in such deals.[74] [Emphasis added.]

A major MNC is not an "honest innocent." MNCs, however, should not be acting as if they were playing the audit lottery or hoping that limited tax authority resources would allow them inappropriate tax results. An MNC, which reports to the public through its audited financial statements reflecting the "tax authorities know everything" requirement of Financial Accounting Standards Board Interpretation No. 48, has higher responsibilities, and should work with its outside advisers to achieve tax results that are acceptable to a wide range of stakeholders.

The point is that even for many MNCs with their sizable in-house tax groups, the professional adviser must realize that, in Cooper's words, he "bears a heavy responsibility" because "his standards may become the guiding standards for his client." As an example, the Caterpillar PSI hearing documents disclosed an in-house tax director who claimed that rather than relying on tax risk ratings assessed by his senior staff, he relied on expert tax advice from PwC and McDermott Will & Emery.[75] Tax advisers do have great sway on the actions and decisions of their clients.

To summarize, there is a clear and self-serving need for professional firms to conduct an internal control function performed by senior professionals who are independent of the client engagement and who have a mandate to exercise their judgment of the overall appropriateness of the advice provided to a client.

- Auditor Concerns

An audit firm may not rely unquestioningly on an opinion letter issued by another professional firm. Rather, the audit firm must do sufficient work to conclude that the opinion letter accurately reflects its client's factual situation and is technically correct. Clearly, any opinion letter issued by a firm involved in the promotion or implementation of the client's tax structuring requires an auditor to view that opinion with a degree of skepticism.

Even if an audit firm agrees fully with the opinion of other professionals, its objective is different: It is to issue its opinion on the financial statements of its client. This is in contrast to the client's principal objective of obtaining a tax opinion to determine whether there is sufficient factual basis and legal authority to implement a tax strategy and report the results of it on its tax return. With these different objectives, there are different standards. Frederic Corneel comments:

> Where the firm also provides auditing services to the client, audit and SEC responsibilities must be taken into account. Thus, just because there is "a realistic possibility of success" for taking a particular position on the tax return, it does not follow that the financial statements opined upon in performance of the firm's audit function can adopt that same standard: Where an asset, such as a refund claim, has less than an even chance of success, it probably cannot be reflected on the balance sheet any more than a contingent tax liability can be omitted merely because some arguments can be advanced in support of the proposition that the taxes are not owing. Given the firm's responsibility, the tax lawyer owes the audit partner an obligation of full disclosure.[76]

To date, it is uncertain whether the auditors of MNCs have considered the possibility that their clients' profit-shifting structures might be subject to U.S. tax through application of the ECI rules. Auditors may use the objective benchmark recommended in the first part of this report as a planning tool to help identify those clients for which ECI taxation is a potential issue.

---

[74]Cooper, "The Avoidance Dynamic," 80 *Colum. L. Rev*. 1553, 1578, and 1588 (1980).

[75]*See* PSI, *supra* note 56, at 69.

[76]*See* Corneel, *supra* note 66, at 192. This 2003 guidance from Corneel is even more important in light of above-mentioned PCAOB Rule 3522, which was promulgated in 2006.

With profit-shifting structures already in place for many years (note that Caterpillar's Swiss tax strategy was implemented in 1999[77]) and increased IRS attention to these structures, auditors must address the ECI issue now. They should review the sustainability of existing structures and the need to record or disclose any actual or potential current or prior years' tax liabilities as part of the work required to render an opinion on a client's financial statements. When a client's situation provides a strong case for the presence of ECI in prior years, there will be important issues to consider, including possible restatements of previous filings and whether the MNC has effective internal controls as mandated for public companies.

Audit firms should expand their standard audit procedures as necessary to ensure that they gather sufficient information to test for ECI. Finally, with the increasing risks involved in profit-shifting structures, audit firms should review their internal policies on acceptance of tax consulting work for audit clients and consider whether those standards are sufficiently stringent for higher risk levels.

- Communication of Risk

For clients that have profit-shifting structures or are contemplating one, it is critical that professional advisers convey to their clients both the risks of those structures and how the risks might be minimized. The potential tax risks of ECI are substantial and could have very harmful reporting and financial consequences for an MNC. It was noted earlier that when a foreign group member is subject to tax on its ECI, the statute of limitations does not begin to run until that group member files a tax return on Form 1120-F.[78] Added to this is the potentially higher than 35 percent tax rate (54.5 percent or higher absent the application of a tax treaty to reduce the 30 percent branch rate) that could result in the tax cost being much greater than if no profit-shifting structure had been implemented.[79]

D. Statutory and Regulatory Improvements

If Congress, Treasury, and the IRS are serious about reducing the corrosive effect of MNC profit-shifting structures and the propensity of MNCs and their advisers to promote and implement them, they need to stop maintaining policies and rules that reward this behavior. Changes in the law and regulations are needed that will discourage inappropriate profit shifting and other improper tax structures.

Listed below are actions that Congress, Treasury, and the IRS could take to discourage harmful profit-shifting behavior and equitably increase tax collections. The items are grouped according to whether they require action by Congress.

1. Items not requiring congressional action.

- Modernization of the Income Sourcing and ECI Regulations

Although the existing income sourcing and ECI regulations are sufficient to determine, calculate, and impose ECI tax, this process could be easier and more consistent with other parts of the code if the ECI regulations were updated to reflect modern-day business models such as supply chains and contract manufacturers.[80]

---

[77]When taxation of ECI is appropriate and a CFC has not filed Form 1120-F, ''U.S. Income Tax Return of a Foreign Corporation,'' for a prior year, the statute of limitations will be open for that year. *See* section 6501(c)(3).

[78]*See Redstone v. Commissioner*, T.C. Memo. 2015-237. Although this case has nothing to do with profit shifting, it states that nonfiling of a tax return (in this case a gift tax return) caused the statute of limitations to remain open. The Tax Court explained: ''Sumner [Redstone] did not file a Federal gift tax return reporting the 1972 transfer of stock to the children's Trusts. The notice of deficiency, though issued 41 years after the transfer, was thus timely.'' *Id.* at *21.

[79]*See* Kelley, Koontz, and Kadet, *supra* note 72.

[80]Kadet, ''Attacking Profit Shifting: The Approach Everyone Forgets,'' *Tax Notes*, July 13, 2015, p. 193, at 204:

> The rules in reg. section 1.864-6 (regarding sales of goods or merchandise through a U.S. office) focus closely on the sales contract and not at all on the many critical activities, often performed within the United States, that strongly support not only consummated sales but critical purchase and production functions. Further, the regulations under section 863 have not yet been harmonized with the subpart F FBCSI contract manufacturer provisions in reg. section 1.954-3(a)(4)(iv). And in modernizing the rules on income attributable to production activity (reg. section 1.863- 3(c)(1)), they should be broadened to clearly cover situations where a U.S. group member or other party, whether under a service agreement or otherwise, is conducting production management and related functions for inventory property that is directly acquired by the foreign corporation. In addition, appropriate coordinating rules should be added to reflect the cost-sharing agreement characterization rules of reg. section 1.482-7(j)(3). Finally, regulations under section 864(b) could be issued to clarify when significant activities conducted either directly by a foreign corporation or on its behalf by another person (related or not) will constitute the conduct of a trade or business in the United States. These areas seem the most pressing; the remaining regulations relevant to sourcing and ECI need review for appropriate modernization.

Similar to how Treasury and the IRS issued notices to alert taxpayers to planned regulatory changes for inversions, a notice could be issued to announce planned amendments to sourcing and ECI rules. It could also put all parties on notice that the ECI is subject to higher effective tax rates[81] because of the branch profits tax and the loss of deductions and credits.[82]

Finally, Appendix C in Part 1 of this report noted that in many profit-shifting structures, the foreign group member and one or more U.S. group members conduct extensive joint business activities that may be sufficient to create a partnership for U.S. tax purposes under the broad reg. section 301.7701-1 and -3 rules. When a partnership exists, the foreign group member is conducting a trade or business in the United States as provided by section 875(1). It is recommended that a revenue ruling be issued that provides guidance in identifying when a partnership will be found to exist.[83]

- Designating MNC Profit-Shifting Structures as Listed Transactions

If profit-shifting structures that have the three factors suggesting the existence of a U.S. trade or business and ECI[84] were designated as listed transactions under reg. section 1.6011-4(b)(2), various penalty and disclosure requirements would apply to taxpayers that failed to report the ECI and pay tax. This should encourage some MNCs and their advisers to change or unwind their existing profit-shifting structures. It should also discourage professional firms from pushing risky structures on existing and potential clients because of the disclosure and penalties applicable to any material adviser.[85]

If for any reason Treasury and the IRS determined that the above profit-shifting structures could not be designated as listed transactions, they could be designated as transactions of interest under reg. section 1.6011-4(b)(6).

- Mechanism and Time Frame Permitting MNCs to Unwind Profit-Shifting Structures Without Penalties

To the extent this would not require congressional action, providing administrative relief to unwind profit-shifting structures would encourage compliance and self-reporting of prior years' tax obligations on amended or late filings through abatement of penalties that might otherwise be due.

- Profit-Shifting Structures Implemented Following Inversions and Acquisitions by Foreign Acquirers

Treasury and the IRS should consider issuing a notice to make clear that following any inversion or acquisition of a U.S. corporation by a foreign buyer, the valuation of any transferred assets and the potential for ECI will be priorities for examination.

- Required Disclosure of Private Tax Rulings During IRS Audit

During any audit of an MNC or other taxpayer, to the extent that it does not already do so, the IRS should require disclosure of any private rulings obtained by foreign group members from foreign jurisdictions. Those rulings may grant lower effective income tax rates than the normal statutory rates in those countries. With the disclosure of private letter

---

[81]*See* sections 884 and 882(c)(2). The latter, as well as the open statute of limitations under section 6501(c)(3), will apply for any prior year a foreign group member conducting a trade or business in the United States has not filed any Form 1120-F for that prior year.

[82]An excellent example is the international practice unit recently released by the IRS Large Business and International Division: "Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)," ISI/9422.01_01 (2016). A helpful addition would be a similar document focused on a typical MNC profit-shifting structure, such as one involving critical management and business functions occurring through the efforts of related U.S. group members when the zero- or low-taxed foreign group member lacks personnel or a CEO with the knowledge, skills, experience, or authority to actually direct the U.S. group members, which presumably maintain that they are merely independent contractors performing services for the foreign group member. The unit could show how this situation could result in the foreign group member's being engaged in a trade or business in the United States either because (1) the U.S. group members are in fact acting as agents for the foreign group member; or (2) the relationship of the group members and their common business activities create a separate entity for federal tax purposes and thus a partnership under the check-the-box rules (reg. section 301.7701-1(a) and -3(b) and section 875).

Another LB&I international practice unit, "Outbound Services by U.S. Companies to CFCs," ISO/9411.07_02 (2013), is also excellent. This unit focuses on services performed by U.S. group members for CFCs and the value of those services. A useful addition would be to question whether the U.S. group members are service providers or instead are agents or proxies conducting the business of the CFC.

[83]*See* Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *Tax Notes*, Apr. 18, 2016, p. 335.

[84]*Id.* at 335.

[85]*See, e.g.*, sections 6111, 6112, 6707, 6707A, and 6708. The status of a professional firm as a disqualified tax adviser under section 6664(d)(4)(B)(ii) would presumably also mean that its opinions on profit-shifting structures would have less value.

rulings, MNC's may face exposure to ECI and the imposition of additional U.S. tax.[86]

2. Items requiring congressional action.

• Increased Standard for Avoidance of Penalties

Congress should harmonize the tax and accounting standards[87] by amending the current penalty provisions for taxpayers, tax return preparers, and advisers from the current "substantial authority" level to the "more likely than not" level.[88] The reasons for this were best articulated by Bret Wells in his 2010 paper:

> It is time for change, and the change that is needed is that tax advisors and taxpayers should only be allowed to claim tax positions that they believe are likely to be sustained after adequate legal and factual due diligence. Taxpayers should not be allowed to swear that their tax liabilities are a lower amount on the tax return and then swear in their publicly-filed financial statements that their belief is different. The truth from the perspective of the taxpayer should be one consistent story. The tax laws should encourage taxpayers to correctly pay their taxes and should encourage them to only take tax positions where the taxpayer reasonably believes that they are likely to sustain their right to the claimed tax benefit after adequate due diligence. Taxpayers and their tax advisors should not contribute to the nation's tax gap by claiming tax positions that they do not believe are sustainable. The tax gap should be reduced to include only tax issues where there is truly a legitimate difference of opinion between what the taxpayer believes is the likely tax liability and the amount that the government truly believes is the likely tax liability. The government should not be required to waste time on issues where taxpayers do not believe in their own positions and where the taxpayer has not engaged in adequate due diligence on their tax positions because they know that the tax laws give them leniency to wait and see what happens in a possible future tax audit.[89]

• Broadened Categories of Persons Subject to Penalties

The law now contains language imposing penalties under various circumstances on taxpayers, tax return preparers, and material advisers.

There is an inherent conflict of interest often present when an MNC's CEO and other senior management, who earn equity-based compensation, approve risky profit-shifting structures that may result in a direct financial benefit to them. These individuals should be added to the list of persons subject to penalties if they are involved with planning, approving, or implementing any reportable transaction.[90] It is time to put aggressive and abusive profit-shifting strategies of MNCs to the test by requiring that those who so forcefully advocate them have some financial skin in the game.

Also, the regulations under section 7701(a)(36) that define tax return preparer should be amended to clarify that any tax adviser that advises not to prepare a tax return when it is later found that a tax return should have been filed should be considered a tax return preparer for that return. The section 6694 tax return preparer penalty would then apply to persons advising against filing a tax return. This would apply to situations involving profit-shifting structures in which a foreign

---

[86]For example, a foreign group member established in Luxembourg and earning royalty income obtains a private ruling providing for no taxation in Luxembourg. Assume the MNC's U.S. headquarters made all decisions in structuring the license arrangements. The Luxembourg group member may have ECI from the royalty income that is directly taxable by the United States. (*See* reg. section 1.864-6(b)(2)(i).)

A second example involves a non-U.S.-based MNC that acquires through a U.S. subsidiary (Buyer) a previously unrelated U.S. company (Target). The non-U.S. parent company arranges financing of Buyer's acquisition of Target by setting up a Luxembourg company that makes interest-bearing intercompany loans to Buyer. Buyer does not withhold the 30 percent U.S. tax on the interest payments based on the lender's qualifying for specific benefits of the Luxembourg-U.S. tax treaty. Assume the Luxembourg lender has a private ruling that allows low or zero taxation in Luxembourg. This private ruling should cause the lender not to qualify as a resident under the Luxembourg-U.S. tax treaty because of its limitation on benefits provision. This would require the borrower to withhold 30 percent tax on all intercompany interest payments made to the lender.

[87]FIN 48 and FASB Codification Topic 740-10-25-5.

[88]When the economic substance doctrine was codified in the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, it did not include language from an earlier bill concerning application of the "more likely than not" standard for some large or publicly traded companies. *See* H. Rep. No. 111-443(I), at 62 (Mar. 17, 2010) (regarding section 453(d)).

[89]Wells, "Voluntary Compliance: 'This Return Might Be Correct But Probably Isn't,'" 29 *Va. Tax Rev*. 645, 693 (2010). Changes to reflect the "more likely than not" standard would be made in sections 6662 and 6694, as well as in Circular 230.

[90]*See* reg. section 1.6011-4(b).

group member is conducting a trade or business in the United States and is required to file a U.S. tax return on Form 1120-F.

- Consideration of Principles-Based Rules

Over the past few years, Congress has considered different proposals advocating international tax reform. We encourage Congress to consider less technically complicated but more broad-based (in contrast to highly technical rules-based) mechanisms to ensure that profits will be taxed where the activities that generate them take place. This circles us back to the beginning of Part 1 of this report and *Gregory*,[91] which still stands strongly for applying the intent of the statute. We also noted in Part 1:

> The very complexity and overly technical nature of U.S. tax law may actually be a godsend for MNCs' managements and their advisers, perhaps giving them cover in some cases for failing to conscientiously fulfill their ethical obligations to employers, stakeholders, and society at large.

Code provisions should set out in simple language the intent and guiding principles by which taxpayers may structure their business and investment activities. Fewer detailed rules would provide less cover for structures that meet the language of the code but result in economics contrary to what was intended. The goal should be to simplify and broaden the tax law to achieve greater taxpayer compliance and higher standards of behavior (more "principled behavior") among management and professional advisers, while at the same time ensuring U.S.-based MNCs remain competitive.

[91]*Gregory v. Helvering*, 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

V. Conclusion

Part 1 of this report proposed an ethical benchmark for determining whether an MNC's tax structuring is acceptable or instead has crossed the line in an attempt to avoid U.S. taxation. MNCs are encouraged to use this benchmark internally to determine whether any of their tax structures should be changed or unwound. If helpful, an MNC in an effort to demonstrate good corporate citizenship, or to disprove accusations of inappropriate tax behavior, could prepare a factual report showing that the income within each of its zero- or low-taxed foreign group members is not in fact earned through U.S.-based value drivers, management, and business activities. For that summary to be fully accepted and trusted, it must be made public and be verifiable by independent persons.

This second half of the report makes several suggestions to MNC boards of directors and managements, professional firms, Treasury, the IRS, and Congress regarding steps that could be taken to both lift the ethical standards of MNCs and more effectively apply the tax laws, thereby creating a more level playing field for all taxpayers. ■