vivos gifts according to asset category, method of conveyance, and donee population.

Finally, the bulletin surveys the use of the business research credits claimed by C corporations on Form 6765. The data reveal trends in the so-called section A regular credit and the section B alternative incremental credit. Real estate investment trusts, regulated investment companies, and S corporations were excluded from the analysis.

For 2005, donors reported inter vivos gifts of $38.5 billion, taking the form of cash, securities, real estate, and other assets. Over 97 percent of that amount was nontaxable.

The number of claimants and the amount of research credits generally declined from 2001 to 2004. A sharp increase appears in the data for 2005, with the number of claimants rising 10 percent, to just over 11,000 corporations, and the value of credits claimed increasing by 14 percent, to $6.4 billion. As expected, the majority of claimed research credits, roughly 70 percent, were attributable to the industrial sector. ■

ECONOMIC ANALYSIS

Extraordinary Profitability in Low-Tax Countries

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Last week Democratic Sens. Carl Levin of Michigan and Byron L. Dorgan of North Dakota received a lot of press claiming that a just-released report they requested provided striking evidence that transfer pricing abuse was rampant among U.S. multinational corporations. The Government Accountability Office found that two-thirds of U.S. corporations pay no income tax. We pointed out that at best, the GAO report was weak evidence that U.S. corporations are shifting profits out of the United States. (*Tax Notes*, Aug. 18, 2008, p. 624, *Doc 2008-17547*, *2008 TNT 157-2*.) That's because the GAO report is mostly about very small corporations that do not even use transfer pricing.

But this week — almost as if on cue — the IRS released new data that do indeed indicate transfer pricing abuse. Figure 1 is one view of that data. It shows that manufacturing subsidiaries of U.S. corporations in low-tax countries have high profitability, while manufacturing subsidiaries in high-tax countries have low profitability. The inverse relationship between the rate of tax and rate of profit suggests that U.S. corporations are adjusting transfer prices between affiliates to shift profits from high- to low-tax jurisdictions.

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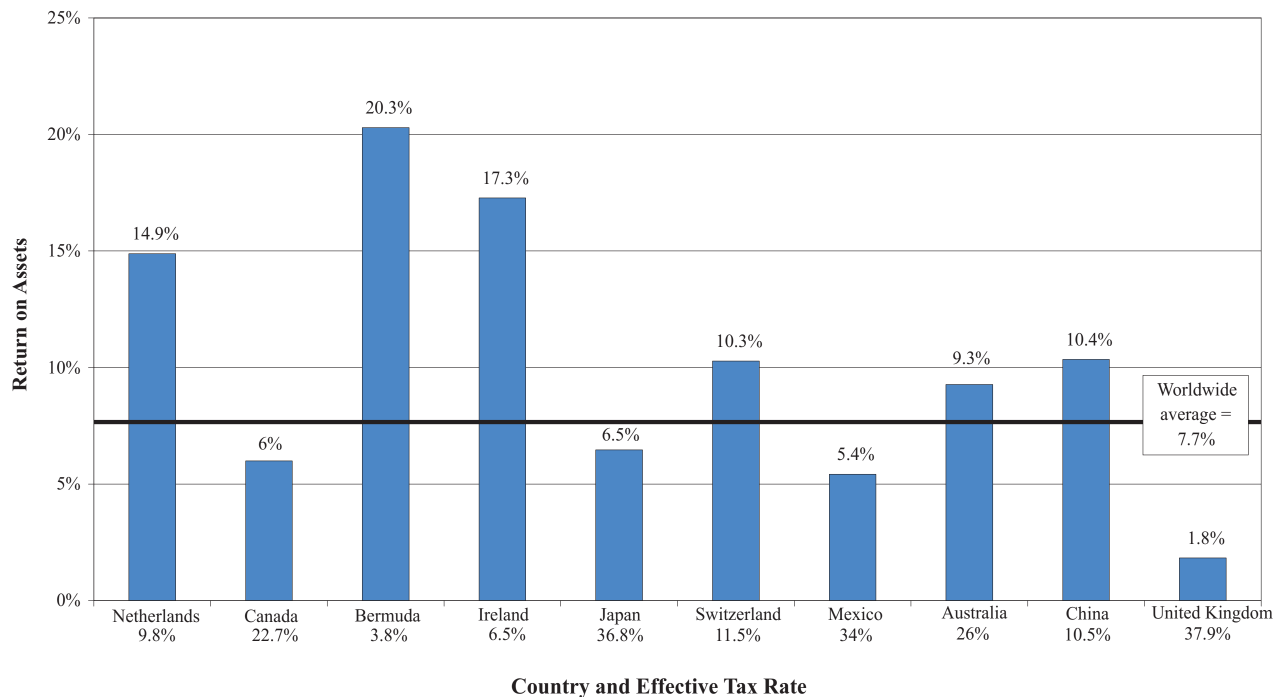
Figure 1 shows the return on assets for the 10 nations that accounted for the most foreign manufacturing profits generated by U.S. multinationals. From left to right we move from the largest (Netherlands) to the 10th largest (United Kingdom).

The five countries with manufacturing assets earning the highest returns — the Netherlands (14.9 percent), Bermuda (20.3 percent), Ireland (17.3 percent), Switzerland (10.3 percent), and China (10.4 percent) — all had effective tax rates (income tax divided by before tax profits) of less than 12 percent. The five countries with the lower returns — Canada (6 percent), Japan (6.5 percent), Mexico (5.4 percent), Australia (9.3 percent), and the United Kingdom (1.8 percent) — all had effective tax rates

Figure 1. Profitability of *Manufacturing* Subsidiaries of U.S. Multinationals, Top 10 Countries of Incorporation, 2004



Source: Lee Mahony and Randy Miller, "Controlled Foreign Corporations, 2004," *Statistics of Income Bulletin*, IRS, Summer 2008 (http://www.irs.gov/pub/irs-soi/04coconfor.pdf). See notes for details.

in excess of 23 percent. If transfer pricing enforcement were not a problem, we would not be seeing this systematic divergence in profitability from the worldwide average. Low tax rates attract profit like a magnet attracts ball bearings. Our current transfer pricing rules provide little resistance.

None of this is news to our regular readers. We have been reporting results like these for years using three data sources: annual report data, data from the Bureau of Economic Analysis of the Commerce Department, as well as IRS data like what you see here. (See end notes for more details.) Although the data confirm known trends, they are notable because updates of IRS data are published only once every two years.

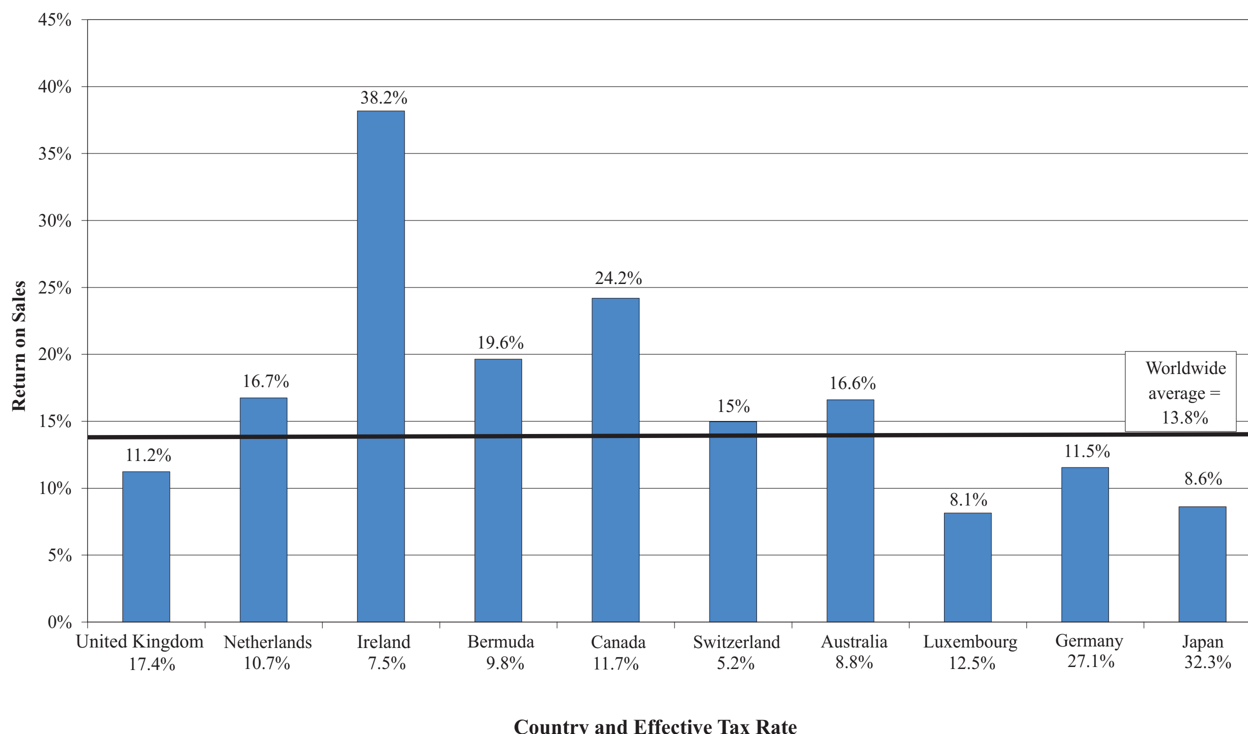
Where the Profits Are

Low-tax Ireland is particularly prone to high profitability. In addition to more than doubling the average return in manufacturing, service, and distribution subsidiaries in the Emerald Isle have the highest rates of return in figures 2 and 3. Some in Ireland fancy they are more productive than the rest of the world. More romantic types talk about the luck of the Irish. But international tax practitioners know that it's transfer pricing.

Subsidiaries legally domiciled in low-tax Switzerland and Bermuda are not far behind those from Ireland. More service-sector profits of U.S. multinationals are located in Switzerland than anywhere else outside the United States, and the rate of profit there is close to the world's highest (Figure 3). Bermuda, in addition to its first-place finish in manufacturing profitability (Figure 1), places third in service-sector profitability (Figure 3).

> ***It is as commonplace for U.S. corporations to shift inordinate amounts of profit into their foreign subsidiaries as it is for otherwise law-abiding citizens to break the speed limit.***

So, senators, here is evidence you can sink your teeth into. These data are a basis for action. Despite all the new regulations and penalties, and despite the IRS's "successful" advanced pricing agreement program, it is as commonplace for U.S. corporations to shift inordinate amounts of profit into their Irish, Swiss, and Bermuda subsidiaries as it is for otherwise law-abiding citizens to break the speed limit.



Plugging loopholes in the cost-sharing regulations is good place to start correcting the problem. But bolder action is required for lasting change — things like tripling enforcement efforts, overhauling the APA program, switching from the arm's-length to the formulary apportionment method of allocating profits, or reducing the statutory corporate tax rate to 25 percent. As the experience of the last two decades shows, modifications to the status quo will not cut it.

Notes

All of the data in this article were from Table 3 of the study by Lee Mahony and Randy Miller, ''Controlled Foreign Corporations, 2004,'' *Statistics of Income Bulletin*, IRS, Summer 2008 (http://www.irs.gov/pub/irs-soi/04coconfor.pdf), released on August 18, 2008.

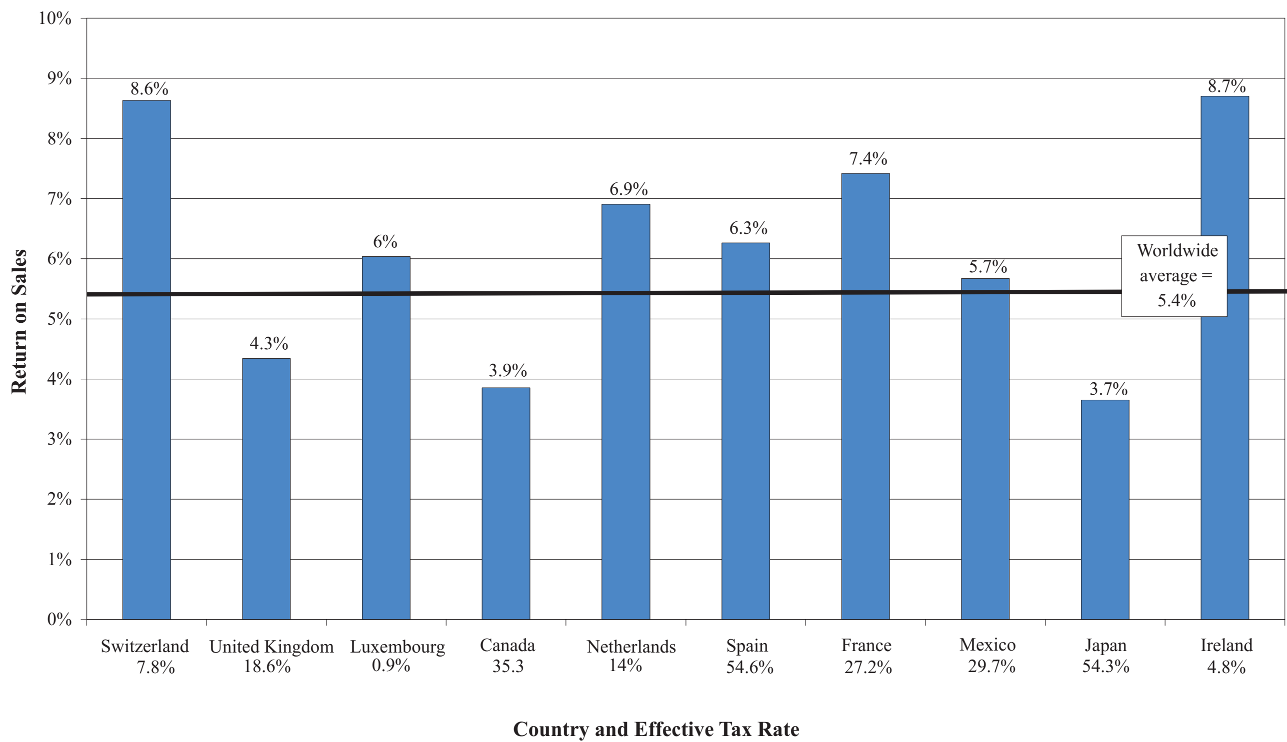
Effective tax rates are the ratio of foreign income tax to current earnings and profits (less deficit) before income taxes.

Two measures of profitability are used. The first, return on assets, is the ratio of current earnings and profits to the average of beginning-of-year and end-of-year assets. The second, return on sales, is the ratio of current earnings and profits to total receipts. These measures are far from perfect but are the best available, given the IRS data.

The author's prior experience in transfer pricing practice suggests that of the two, return on assets was the more appropriate measure for manufacturing (Figure 1) and return on sales (figures 2 and 3) was the more appropriate measure for services and distribution businesses.

In figures 1, 2, and 3, countries are ranked from left to right in the order of amount of profits earned by U.S. subsidiaries in that particular industry. Effective tax rates shown at the bottom are for the industry.

Many prior Tax Analysts articles discuss inordinate profit shifting by U.S. corporations. Those using Department of Commerce data include: ''U.S. Multinationals Shifting Profits Out of the United States,'' *Tax Notes*, Mar. 10, 2008, p. 1078, *Doc 2008-4725*, *2008 TNT 48-3*; ''The IRS Multibillion-Dollar Subsidy for Ireland,'' *Tax Notes*, July 18, 2005, p. 287, *Doc 2005-15012*, *2005 TNT 137-3*; and ''U.S. Multinationals Move More Profits to Tax Havens,'' *Tax Notes*, Feb. 9, 2004, p. 690, *Doc 2004-2725*, *2004 TNT 27-4*. Those using company annual report data include: ''Why Reported Effective Corporate Tax Rates Are Falling,'' *Tax Notes*, Mar. 3, 2008, p. 977,



Doc 2008-4060, *2008 TNT 43-9*; "Drug Firms Move Profits to Save Billions," *Tax Notes*, Aug. 7, 2006, p. 472, *Doc 2006-14640*, *2006 TNT 152-5*; "High-Tech Companies' Tax Rates Falling," *Tax Notes*, Sept. 4, 2006, p. 818, *Doc 2006-18379*, *2006 TNT 171-6*; "Drug Firms Park Increasing Share of Profits in Low-Tax Countries," *Tax Notes*, Sept. 20, 2004, p. 1336, *Doc 2004-18272*, *2004 TNT 183-3*; and "Large U.S. Banks Keeping More Profits in Tax Havens," *Tax Notes*, June 14, 2004, p. 1340, *Doc 2004-12255*, *2004 TNT 116-10*. And a prior article using an earlier version of the IRS data presented here is: "Latest IRS Data Show Jump in Tax Haven Profits," *Tax Notes*, Oct. 11, 2004, p. 151, *Doc 2004-19778*, *2004 TNT 198-5*. ■