Can BEPS Be Addressed Through the Sourcing Rules? Prof. Jeffery Kadet Looks to the US' ECI

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Attacking Profit Shifting by Prof. Jeffery Kadet (Abstract) In recent years the financial press has turned increasing attention to MNCs that shift income to low taxed jurisdictions overseas in order to avoid US taxation. What's generally missing from these discussions is any serious focus on possible IRS attacks on these companies, most of which are CFCs. There's little apparent concern by anyone that the IRS will try to disallow the profit-shifting structures that have moved so much taxable income out of the US and other countries and into low-taxed foreign jurisdictions.

This is changing. Early this year Caterpillar Inc. in an SEC filing disclosed that the IRS had issued a Revenue Agent's Report to currently tax certain income earned by one of its Swiss entities. Presumably this is income earned as a result of a certain restructuring conducted in the late 1990s and referred to as the Swiss Tax Strategy when examined in 2014 in hearings held by the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (PSI).

The IRS basis for its RAR, as disclosed by Caterpillar, is application of the 'substance-over-form' or 'assignment-of-income' judicial doctrines. This, however, is not the only approach that the IRS might have chosen to impose taxation on the shifted profits.

Various Congressional hearing documents, the work of investigative journalists, and other sources (all publicly available) provide evidence that the businesses within some profit-shifting structures continue to be managed and substantially conducted from the U.S. and not from any business locations outside the U.S. Where this is the case, the IRS may have a strong case for imposing direct taxation on the effectively connected income (ECI) of these low-taxed foreign subsidiaries.

Just the *threat* of imposing direct taxation may cause many MNCs to consider scaling back their profit shifting and for them and their outside auditors to start worrying about exposure on prior years. If the IRS were to sustain such direct taxation, it would mean:

· The regular up-to-35% corporate tax,

· The 'branch profits tax' applied at a flat 30% rate (unless lower by treaty),

· A loss of deductions and credits for any tax year if the foreign corporation has not filed Form 1120-F for that year, and

· An open statute of limitations on IRS assessment of tax for any tax year if the foreign corporation has never filed a US tax return on Form 1120-F for that year.

The combined effect of the above is a *54.5% or higher* effective tax rate (lower if tax treaty coverage reduces the 30% branch profits tax rate).

Considering these terribly high effective tax rate percentages, where the IRS chooses to examine for possible ECI and develops a credible case, they can use the high effective tax rate as strong leverage to secure agreement for reversal of profit shifting structures. Such agreements would presumably see MNCs agreeing to current taxation within U.S. group members of the shifted profits that had originally been booked in low-taxed foreign subsidiaries.

To demonstrate how significant ECI likely exists within many MNCs that have conducted profit-shifting planning, this article includes a number of realistic examples inspired by the above-mentioned publicly available information on MNC profit-shifting structures.

Recognizing that it can sometimes be a challenge to apply the very old existing regulations to current business models, the article strongly encourages Treasury to prioritize the issuance of modernized income sourcing and ECI regulations that reflect the business models and structures now commonly used and that are often found in profit-shifting structures.

See the full article at Attacking Profit Shifting by Prof. Jeffery Kadet