February 7, 2020

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

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. 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 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.  

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.

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

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
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, 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. 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. 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”) 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. 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. 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). The most well-known of

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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.


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. 

As a final comment, government policymakers around the world (now through the almost 140 country Inclusive Framework), 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. 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. 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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13 See page 46 of Apple Inc.’s 2019 Form 10-K and page 16 of Apple Inc.’s Q1 2020 Form 10-Q.
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). While not suggesting that Apple had done anything illegal, some of those at the hearings were less than complementary about Apple’s structuring. A memorandum dated May 21, 2013, issued by Senators Levin and McCain in connection with the hearings, considered matters such as...

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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. 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. The group’s U.S. personnel count of 90,000 represents over 65% of its total employment of 137,000 and 90% of its long-lived assets are in the U.S. or China 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):

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.


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.

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,

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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


\(^{29}\) 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 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.\textsuperscript{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.

\textsuperscript{30} Available at \url{http://eur-lex.europa.eu/legal-content/en/TXT/PDF/?uri=uriserv%3AOJ.C_2017.053.01.0037.01.ENG}.

\textsuperscript{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 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. [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.
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

Profit shifting: Effectively connected income and financial statement risks

Multinational corporations could be subject to high levels of tax on effectively connected income.

By Thomas J. Kelley, CPA (retired), MBA; David L. Koontz, CPA (retired); and Jeffery M. Kadet, CPA (retired), MBA
In recent years, the financial press, governmental authorities in many countries, the G-20, and the Organisation for Economic Co-operation and Development have increasingly turned their attention to multinational companies (MNCs) that shift income to lower-taxed foreign jurisdictions to avoid taxation. There is a growing sense that certain large blue chip companies have availed themselves of tax planning that relies too much on form and artifice rather than serious and substantive business planning intended to enhance their products, increase market share, and improve profitability.

Companies coming under this scrutiny include those that have “inverted” into foreign ownership, foreign-based MNCs owning a business actively conducted in and managed from the United States, and U.S.-based MNCs. U.S.-domiciled companies alone have reportedly parked more than $2 trillion of their low-taxed foreign earnings overseas (“U.S. Companies Are Stashing $2.1 Trillion Overseas to Avoid Taxes,” by Richard Rubin, Bloomberg Business, March 4, 2015). Adding in the profits shifted by foreign-based MNCs that otherwise would be taxable in the United States would significantly increase this figure.

Given all this attention, it is now critically important that MNCs ensure that their planning and use of offshore companies fully complies not only with the letter but also with the spirit of the law. If this is the case, then there should be little concern about an IRS examination into transfer pricing or other profit-shifting practices. But this will not be true for companies that have elevated form over substance and have over-relied on internally generated documents and contracts. And as the IRS learns more about MNC profit-shifting techniques, where warranted, it may begin applying Secs. 11, 882, and 884, which impose direct taxation on the effectively connected income (ECI) of foreign corporations, to prevent abuses by MNCs. The IRS’s successful application of the ECI rules could have devastating tax and financial statement consequences for any affected MNCs, for two simple reasons:

- ECI can be taxed at a rate of more than 50% or even higher, often including years that were thought to be closed, and
- Such taxation would cause significant financial statement tax provisions, especially for the many MNCs that have used Accounting Principles Board 23, Accounting for Income Taxes—Special Areas, to avoid accruing any foreign taxes on shifted profits.

For anyone expecting congressional adoption of a territorial tax system, there will be no comfort since these ECI rules would remain in full effect to directly tax shifted profits when warranted.

This article aims, first, to provide CFOs, in-house tax professionals, and outside auditors or advisers practical guidance to determine whether their companies’ and clients’ fact patterns would clearly support a finding of having ECI. Second, if those individuals see reason for concern, this article provides practical guidance on the financial statement and tax risks and what to do about them.

While this article focuses on financial statement and tax risks, where the ECI risk is high, any affected company will face a multitude of other concerns, including cash flow issues, compliance with banking and loan agreements, potential effects on awards under employee compensation plans, foreign exchange and currency issues, and potentially even questions about business ethics.

GROWING IRS AWARENESS OF PROFIT SHIFTING AND IMPLICATIONS

The Senate Permanent Subcommittee on Investigations held hearings in 2012, 2013, and 2014 directed at specific companies that it believed had been shifting profits out of the United States. Following the 2014 hearings on Caterpillar, as disclosed in Caterpillar’s Form 10-K of Feb. 17, 2015, the IRS in January 2015 issued a Revenue Agent Report proposing tax increases and penalties of approximately $1 billion relating to certain income earned by Caterpillar’s Swiss entity, Caterpillar SARL. The basis for most of the IRS claim was application of the substance-over-form and/or assignment-of-income judicial doctrines. Caterpillar is contesting this adjustment and stated in its Form 10-K that the transactions “complied with applicable tax laws and did not violate judicial doctrines.”

Microsoft was examined by the subcommittee in 2012. The IRS has attacked Microsoft’s transfer pricing involving intangibles in connection with several internal group cost-sharing agreements that played an important part in its profit-shifting efforts. Microsoft testified at that hearing that it “complies with the tax rules in each jurisdiction in which it operates and pays billions of dollars in total taxes.” This dispute is ongoing.

Last September, the IRS issued to the Coca-Cola Co. a statutory notice of deficiency for additional taxes of approximately $3.3 billion covering 2007 through 2009. Like the action against Microsoft, the basis for the additional taxes is also transfer...
which is imposed on effectively connected earnings and profits (adjusted by changes in U.S. net equity during the year and reduced in some cases by tax treaties) (i.e., 35% corporate tax, plus 30% of the remaining 65% of income, or an additional 19.5%, which totals 54.5%). Where branch profits are protected by some U.S. treaties, the combined rate could be 38.25% or higher.

Furthermore, this approach is statutorily based and more objective in application. It should not only be easier for the IRS to sustain the ECI approach in court, but it will require CFOs and outside auditors to carefully consider this new tax exposure when applying FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, which importantly requires a presumption that the relevant tax authority has full knowledge of all relevant information.

WHEN COULD AN MNC BE SUBJECT TO THE ECI APPROACH?
The Code and regulations provide detailed rules for calculating a foreign corporation's ECI. In brief, for any foreign corporation that conducts a trade or business in the United States, ECI includes all of that foreign corporation's U.S.-source business income, and it can also include certain foreign-source income. For a detailed description of the ECI tax rules, please see the exhibits with the online version of this article at tinyurl.com/za2en7r.

The ECI approach potentially applies to any MNC that manages one or more business lines within the United States but records significant pricing in connection with the licensing of intangible property. Coca-Cola said in its Sept. 18, 2015, Form 8-K that the assessments are “without merit.”

In the case of Caterpillar, the IRS focused on the company’s Swiss tax strategy under which the bulk of its profits from the sale of certain replacement parts was recognized by a Swiss group member rather than by a U.S. group member, as previously had been the case. The Senate subcommittee’s report makes clear that although the profits were shifted through various entity and contractual mechanisms, the physical business operations remained unchanged, so that the actual conduct and management of the Swiss group member’s business continued to be within the United States. This same fact pattern can be seen in other subcommittee investigations, as well as in other publicly available material. Many other MNCs with one or more businesses managed from operating and headquarters companies in the United States have likely implemented similarly tax-motivated restructurings with a minimum of meaningful operational changes.

In the Caterpillar and Microsoft cases, the IRS pursued, respectively, the substance-over-form and assignment-of-income judicial doctrines and transfer-pricing adjustments, all of which are subjective. However, where an MNC’s fact pattern warrants it, the IRS could impose direct taxation on the ECI of the foreign group members that recorded the shifted profits. Under this approach, such taxes could be imposed at rates of up to 54.5% or higher. To the maximum 35% corporate tax could be added the Sec. 884 branch profits tax of 30%, which is imposed on effectively connected earnings and profits (adjusted by changes in U.S. net equity during the year and reduced in some cases by tax treaties) (i.e., 35% corporate tax, plus 30% of the remaining 65% of income, or an additional 19.5%, which totals 54.5%). Where branch profits are protected by some U.S. treaties, the combined rate could be 38.25% or higher.

Furthermore, this approach is statutorily based and more objective in application. It should not only be easier for the IRS to sustain the ECI approach in court, but it will require CFOs and outside auditors to carefully consider this new tax exposure when applying FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, which importantly requires a presumption that the relevant tax authority has full knowledge of all relevant information.

IN BRIEF

As the IRS gains more experience in understanding the types of profit-shifting structures used by multinational corporations (MNCs), it may more often directly tax the effectively connected income (ECI) of MNCs’ foreign group members.

This approach by the IRS will most often be a concern where (1) the value drivers of the income earned occur in the United States; (2) the control and decision-making for the foreign group member’s business occur in the United States; and (3) there is a lack of any foreign group member CEO and management capability outside the United States.

Where the IRS succeeds in imposing U.S. income tax on the ECI of a foreign group member not protected by treaty, the combined corporate and branch profits tax rates could be 54.5% or higher. If branch profits are protected by treaties, the rate is 38.25% or higher.

In addition, if a foreign group member has filed no U.S. tax return for a prior year, then that year remains open, allowing the IRS to assess tax for all those years at any time and to deny most deductions and credits.

Where a risk exists for the application of the ECI rules, MNCs may be required to disclose and/or accrue material amounts of income tax, interest, and penalties on financial statements issued in prior years, using the full-disclosure assumption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes.

To comment on this article or to suggest an idea for another article, contact Paul Bonner, senior editor, at pbonner@aicpa.org or 919-402-4434.
agreements. Rather, U.S.-located group management simply directs the contractual terms of these vitally important agreements.

**MAJOR ISSUES FOR POTENTIALLY VULNERABLE MNCs**

MNCs exhibiting the three factors described above will need to minimize and resolve potential issues on a number of fronts, which include the following:

**Risk assessment**

CFOs, in-house tax professionals, and outside auditors should seriously assess any tax risk that arises from the possible application of the ECI approach within their own MNC or within their MNC clients. There will often be a steep learning curve because the literature generally, and international tax advisers in particular, appear to have given this risk relatively little attention in published articles or when implementing cross-border profit-shifting structures.

Also, since many of these structures have been in place for a decade or longer, the CFOs, in-house tax professionals, and outside advisers who were involved in their implementation may be long gone.

Risk assessment efforts will typically require detailed and time-consuming fact finding to determine exactly how each foreign group member earns its profits and how related group members have aided it in doing so. Even where international tax advisers seriously considered the risks of the

profits in low-taxed foreign group members. Here, the broader term “group member” rather than “subsidiary” is appropriate because inverted MNCs and other foreign-based MNCs that conduct such lines of U.S.-managed businesses more typically route transactions and earn profits through group members that are not subsidiaries of U.S. group members. U.S.-based MNCs, of course, conduct such transactions and earn profits through their foreign subsidiaries, which have a special status under U.S. tax rules and are often referred to as controlled foreign corporations, or CFCs.

The following three principal factors may subject an MNC and certain of its business lines to the application of the ECI approach.

**Value drivers predominantly performed by U.S. group members.** Crucially important value drivers that allow the applicable foreign group members to generate significant income are predominantly performed by U.S. group members rather than by the foreign group members. Such value drivers can include research and development that create new technologies and products, management and detailed control of the product purchase and production processes, and management of and direct participation in the product sales process.

**U.S.-located control and decision-making.** Often through service agreements or other contractual mechanisms, the U.S. group member performing services for a foreign group member makes business decisions and conducts management activities that in fact represent the U.S. group member’s conduct of that foreign group member’s business. The extensive U.S.-located control and decision-making go far beyond what would be found in any typical unrelated-party situation.

**Lack of foreign group member CEO and management capability outside the United States.** Although a person may be assigned to this position in name, there is no real CEO of the foreign group member who conducts the day-to-day trade or business of the foreign group member from one of its foreign offices. There may also be no foreign group member personnel capable of managing the foreign group member’s businesses or having the experience, knowledge, and authority necessary to direct the U.S. group member service providers. Further, there may be no foreign group member management personnel or directors located outside the United States who are capable of negotiating or even understanding the terms of critical intercompany agreements such as license agreements, cost-sharing agreements, and service agreements. Rather, U.S.-located group management simply directs the contractual terms of these vitally important agreements.
ECI approach when designing and implementing structures years ago, operational procedures today must still be reviewed closely in light of operational and technology changes since implementation.

In assessing risk, CFOs and in-house tax professionals typically have a different perspective from that of their outside auditor. The former are advocates for the success of their MNCs and are concerned with the position of the MNC and its various stakeholders. The latter must approach issues on the independent basis required of an outside auditor and never as an advocate.

Because of Sarbanes-Oxley mandates, profit-shifting structures implemented within the past decade will likely have involved tax advisers other than those from the MNC’s auditing firm. Even if an MNC’s outside auditors already understand the ECI technical tax issues, they will normally still have to conduct considerable additional fieldwork to obtain sufficient evidence on exactly how each foreign group member earns its profits and how related group members have aided the foreign group member in doing so.

**High tax liabilities and penalties**

Besides the corporate tax and possible branch profits taxes involved, interest and penalties could be considerable.

Another, and potentially more significant, aspect of the ECI approach is the number of open tax years available for examination by the IRS. For example, the IRS assessed tax on a Caterpillar U.S. group member for the 2007 through 2009 tax years. This implies that Caterpillar’s U.S. income tax returns filed on Form 1120, *U.S. Corporation Income Tax Return*, for earlier years are already closed and not subject to further IRS examination. However, where the ECI approach is applied so that the taxpayer is the foreign group member and not the U.S. group member, the IRS is free to go back to all years for which the foreign group member has not filed U.S. tax returns. The IRS to use this ECI approach to challenge Caterpillar’s offshore tax planning, it could assess corporate income tax for all years back to 1999 for which Caterpillar’s foreign group members have not filed U.S. tax returns.

**Financial statement effects**

Depending on the level of risk and materiality, financial statements may need to include disclosures and/or reserves for possible taxation, interest, and penalties. Where the ECI approach is successfully applied by the IRS, pretax earnings may be subject to rates substantially in excess of the statutory 35% U.S. corporate tax rate. Accordingly, even if an MNC has accrued a full 35% U.S. residual tax for all years because it is not permanently reinvesting its earnings overseas, there may still be additional taxes in material amounts to disclose and/or accrue. And if the earnings have been treated as permanently reinvested overseas so that no U.S. tax on the repatriated earnings has been accrued, then the amounts of potential taxes, interest, and penalties to be accrued or disclosed could be material.

Any additional taxes, interest, and penalties that must be accrued under applicable accounting rules such as FIN 48 will directly reduce an MNC’s reported profits and earnings per share. This will be of concern to the board of directors, management, shareholders, lenders, and others who have a stake in anything that materially affects an MNC’s reported earnings. In addition, other regulatory issues may arise, including the potential for restatements of previous-period filings and whether the MNC has in place effective internal controls as mandated for public companies.

Because outside auditors must act independently and follow the full-disclosure presumption of FIN 48, the greater statutory basis provided by the ECI rules may cause outside auditors to require disclosure or accrual for some profit-shifting structures if an MNC’s fact pattern reflects high risk. This is in contrast to risks associated with the more subjective judicial doctrines and potential transfer-pricing adjustments, which arguably provide greater leeway in regard to the need for disclosure or accrual of tax.

**Reconsidering prior decisions on permanent reinvestment of overseas earnings**

Where vulnerabilities exist, senior management should reconsider past decisions made to permanently reinvest certain CFC earnings overseas. Because of such reinvestment decisions, an MNC will have made no accrual of the future U.S. taxes that would be due upon repatriation of its foreign earnings. The level of vulnerability could be a new and important factor that might affect management and the board of directors’ thinking on this “permanent reinvestment” decision.

**Actions to mitigate risk: The past**

As noted earlier, under the ECI approach, the IRS is free to go back and assess tax for any earlier year for which the foreign group member had not...
tax position (UTP) disclosures should be made to the IRS, either on the returns filed for each foreign group member or within the U.S. MNC’s tax returns? Any filings of returns or required UTP disclosure statements will, of course, alert the IRS to issues that it may choose to examine.

A further consideration is that the higher-than-expected 35% corporate tax rate and ability to assess tax on early years may place the IRS in a more favorable bargaining position to effectively force possible compromise settlements on MNCs. It seems likely that compromises would most often involve an MNC agreeing to treat some amount of foreign group member income as being the income of a U.S. group member to avoid the higher direct taxation of its foreign group members applicable under the ECI approach. In addition, since only the more recent years of U.S. group members would remain open, a compromise would likely protect any foreign group member earnings from earlier years.

Because substantial amounts might have to be accrued or disclosed in an MNC’s financial statements, there is a good chance that further public disclosures will be triggered. With this in mind, an MNC’s financial and tax personnel will normally want to alert management and the board of directors as soon as possible. This suggests covering the risk assessment and mitigation process in early presentations to management and the board. These presentations should also include the basis for the MNC’s prior tax planning strategies.

Actions to mitigate risk: The future

If an MNC’s management determines that its profit-shifting structures involve considerable risk of the IRS’s applying the ECI approach, it should immediately consider mitigating this risk. Note that if the United States enacts international tax reform filed U.S. tax returns on Form 1120-F. Further, if returns have not been filed, the IRS may calculate tax payable without allowing a taxpayer to claim certain deductions and tax credits under Regs. Sec. 1.882-4(a)(3)(i). This is why the actual tax rate could be even higher than 54.5%. (Note that including required disclosures about a foreign group member on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, filed within a U.S. parent company’s Form 1120 does not constitute having previously filed U.S. tax returns for the foreign group member.)

If a risk assessment suggests an exposure to ECI, CFOs and in-house tax professionals must consider the pros and cons of now filing U.S. tax returns for their foreign group members for some or all prior years. And, if a decision is made to file those returns, what exactly should be reported on them? Should they be prepared showing income and paying tax? Or should the filings be made on a “protective basis” to merely start the running of the statute of limitation? Further, what uncertain
including a territorial tax system, the risks associated with the use of the ECI approach would remain.

First, could any structural or intercompany contractual changes be made to reduce the potential risks? For example, if a service agreement between foreign and U.S. group members is priced on a simple cost-plus service fee basis that does not recognize the value that the U.S. group member is providing, perhaps the cost-plus fee could be replaced by some other, more realistic pricing formula or mechanism.

Second, since high risk arises primarily from the above-mentioned value drivers and control and decision-making occurring within the United States by U.S. group personnel, any effort to mitigate risk must include consideration of operational modifications that would change the location of those value drivers and management functions.

Third, recognizing that operational management may be less than enthusiastic about any meaningful operational changes that would truly add substance to and strengthen a profit-shifting structure, the CFO and in-house tax professionals must include in their analyses the possibility of unwinding the existing structures that are determined to be high-risk.

Equity-based compensation plans may encourage MNC management to aggressively pursue profit-shifting structures. These compensation arrangements incentivize management to reduce an MNC’s effective tax rate to increase after-tax earnings and share prices. Although this is not a direct approach to minimizing the risk from current profit-shifting structures, boards of directors should consider the relevance of this issue to their MNC’s equity-based compensation plans and, where appropriate, amend them to measure effectiveness and results in some pretax manner.

In summary, after careful consideration of the foregoing, MNCs and their advisers should take action to mitigate risk for past years as well as to mitigate risk for future years. In some cases, it may be appropriate to unwind existing profit-shifting structures.
Overview of the ECI rules
By Thomas J. Kelley, CPA (retired), MBA; David L. Koontz, CPA (retired); and Jeffery M. Kadet, CPA (retired), MBA
February 1, 2016

This sidebar accompanies the article “Profit Shifting: Effectively Connected Income and Financial Statement Risks (/issues/2016/feb/profit-shifting-effectively-connected-income.html)” in the February 2016 issue of the JofA.

This sidebar provides a brief explanation of the Internal Revenue Code’s effectively connected income (ECI) rules that may impose direct U.S. tax on certain income earned by any foreign corporation. This includes foreign corporations that are subsidiaries of U.S.-based multinational corporations. For a more detailed understanding of how this ECI approach can apply to typical profit-shifting structures, see Kadet, “Attacking Profit Shifting: The Approach Everyone Forgets,” 148 Tax Notes 193 (July 13, 2015). The full article is available at http://ssrn.com/abstract=2636073 (http://ssrn.com/abstract=2636073).

The overall concept

The Internal Revenue Code, in a manner roughly similar to the tax laws of most other countries, imposes tax on the business income of a foreign corporation only when the business activities of that foreign corporation within the United States rise above some minimum threshold. This generally involves business activities conducted by the employees of the foreign corporation or by agents acting on the corporation’s behalf. When there is no specific agency agreement granting agency powers, an agency relationship may be inferred from the actions of the parties.

It is fair to say that the low-taxed foreign group members that are the subject of the accompanying JofA article (/issues/2016/feb/profit-shifting-effectively-connected-income.html) seldom, if ever, conduct business in the United States through their own employees. Rather, they typically enter into service or similar agreements with U.S. group members under which a U.S. group member performs various activities for the foreign group member.

Under normal circumstances, a service agreement will not cause the service provider to become an agent of the person for whom the provider performs the services. However, in many profit-shifting structures, the foreign group member has no personnel of its own capable of managing or conducting its
own business. Further, the foreign group member has no CEO or other management personnel regularly working in a foreign group member office outside the United States who are capable of directing the U.S. group member service provider in its activities.

Through the mechanism of a service or similar agreement, the U.S. group member service provider will typically make day-to-day business decisions and take actions independently that directly benefit the foreign group member and obligate it with respect to third parties in a manner that far exceeds what a typical unrelated service provider would be permitted to do. These decisions and activities, which are conducted on a regular and continuing basis, also go far beyond any normal shareholder oversight of a foreign subsidiary’s conduct of its own business. The effect is that the totality of these services performed by the U.S. group member service provider on behalf of the foreign group member may equate to the exercise of agency powers, which results in the conduct of a U.S. trade or business by the foreign group member.

In addition, many foreign group members effectively conduct significant joint activities with one or more of their U.S. group members. For example, teams of personnel typically located within the United States will control and direct all contract manufacturers that are producing products that will be directly acquired by the foreign group member and one or more U.S. group members. As another example, personnel from both U.S. group members and foreign group members will work together in marketing, sales, and customer support both from a strategic perspective and on specific sales opportunities to new and existing customers. Where there are such joint activities, they may create a partnership for U.S. tax purposes. The broad statutory definition of partnership and the judicial interpretations characterizing joint activities, whether in legal entity form, through contractual relationships, or by the actual activities of the related companies, will often make a compelling case that a foreign group member and certain of its U.S. group members should be seen as operating in partnership form for federal tax purposes.

When the joint activities carried on by a foreign group member and its U.S. group members constitute a partnership for U.S. tax purposes, then by statutory definition, the foreign group member will be engaged in a trade or business in the United States.

Once the foreign group member is engaged in a trade or business in the United States, certain defined business income will be treated as ECI, and the foreign group member will be directly taxable on this income in the United States. This condition of being engaged in a trade or business within the United States is a threshold test. If a foreign group member is not engaged in a trade or business within the United States, there can be no ECI and no U.S. taxation.

**What U.S. tax applies to ECI?**

When a foreign group member earns ECI, it is subjected to several levels of tax as well as special rules applicable to any tax year for which the IRS assesses tax and for which the foreign group member has not previously filed a U.S. tax return on Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*. The taxes and special rules applicable to the ECI of a foreign group member are:
• The regular, up-to-35% corporate tax rates applicable to all corporate taxpayers;

• The branch profits tax applied at a flat 30% rate to ECI after reduction for the up-to-35% regular tax and other possible adjustments (a rate lower than 30% may apply if the foreign group member is entitled to tax treaty benefits that the foreign group member’s country of residence maintains with the United States);

• A loss of deductions and credits for any tax year if the foreign group member has not filed a U.S. tax return on Form 1120-F for that year; and

• An open statute of limitation on IRS assessment of tax for any tax year if the foreign group member has never filed a U.S. tax return on Form 1120-F for that year. (The statute remains open for a tax year, even though that same year may already be closed to further IRS assessment for related U.S. group members.)

The combined effect of the above is:

• Where no tax treaty is available to reduce the branch profits tax below its normal 30% rate, the effective tax rate on ECI could reach 54.5% or higher. The 54.5% calculation includes the 35% corporate income tax + 30% branch profits tax on earnings after imposition of corporate income tax (0.3 × 0.65, or 19.5%). The phrase “or higher” signifies the loss of deductions and credits that occurs if no tax return was filed.

• When a foreign group member is entitled to the benefits of a tax treaty that reduces the branch profits tax rate, then the above-calculated rate of 54.5% or higher will be lower. For example, when the normal 30% branch profits tax rate falls to 5%, as it does under the Switzerland–United States tax treaty, the combined rate is 38.25% or higher. The 38.25% calculation is: 35% corporate income tax + 5% branch profits tax on earnings after imposition of corporate income tax (0.05 × 0.65, or 3.25%).

The above 54.5% or 38.25% or higher rates that apply when a foreign group member is directly taxed compare very unfavorably with the maximum 35% corporate tax rate imposed when income is taxed within a U.S. corporation and the branch profits tax and the potential loss of deductions and credits are not applicable. Further, a foreign group member that has earned ECI in any early years that are still open because the foreign group member filed no Form 1120-F may be assessed tax by the IRS at any time.

Technically, as a foreign corporation, a foreign group member may claim a foreign tax credit as an offset to its U.S. tax liability for any foreign taxes that it may have paid or accrued on its ECI. However, it seems likely that the foreign tax credit limitation would often prevent a full credit, since the ECI being taxed will be defined as U.S.-source income under the Code’s applicable income-sourcing rules. Therefore, unrelieved double taxation could result in some circumstances. Despite this, instances of significant double taxation should be rare, since most profit-shifting structures will have been planned to avoid not only current U.S. taxation but also taxation in foreign countries where operations occur or sales are made.
What is ECI?

Sales income

Assume that a foreign group member earns sales income from purchasing and selling products. The foreign group member has no employees or offices of its own but, rather, has a service agreement with a related U.S. group member under which personnel operating from within the United States control all product purchasing, control and maintain relationships with major distributors and key customers worldwide, and negotiate the terms of the sales contracts with these major distributors and key customers.

Assume further that the foreign group member, through its disregarded entity (DRE) subsidiaries (see explanation below) maintains some local warehousing and customer support functions in various countries around the world. The activities performed by the U.S.-related company under the service agreement amount to that company’s exercising agency powers for the benefit of the foreign group member. Furthermore, assume this has met the above-mentioned threshold test of being engaged in a trade or business within the United States. Finally, assume the foreign group member has no CEO conducting its day-to-day trade or business from a foreign office.

A DRE subsidiary is a creation of the IRS check-the-box rules, under which a qualifying 100% owned subsidiary can elect to be treated, solely for U.S. tax purposes, as a branch or division of the subsidiary’s owner. For example, when this election is made, a warehouse operated by the subsidiary of a foreign group member, along with the subsidiary’s employees, will be treated for U.S. tax purposes as being owned and operated by, and employed within, a branch of the foreign group member.

Certain U.S. tax rules define the source of different types of income. Where a foreign group member has met the test of being engaged in a trade or business within the United States, all of certain types of income that are U.S.-source, including sales income, will be ECI subject to tax.

The following questions must be answered to determine whether sales income is sourced within the United States and is therefore treated as ECI. If the answer to every question is yes, the income will be U.S.-source and taxable as ECI:

1. Does the foreign corporation maintain an office or other fixed place of business in the United States (a U.S. office) (see Secs. 865(e)(2) and (3) and 864(c)(5)(A))?

2. Does the foreign corporation have income from any sale of personal property (including inventory property) attributable to that U.S. office (see Secs. 865(e)(2) and (3) and 864(c)(5)(B))?

3. For any such income attributable to that U.S. office, does any arise from:
   - Inventory property sold for use, disposition, or consumption inside the United States; or
   - Inventory property sold for use, disposition, or consumption outside the United States where no
office or other fixed place of business of the taxpayer in a foreign country (foreign office) materially participated in the sale (see Secs. 865(e)(2)(B) and 864(c)(3))?  

Detailed regulations provide rules and examples for applying each of these three questions. Regarding the above-described foreign group member for which its related U.S. group member is performing the described activities, these rules and examples would likely find that the first two questions have “yes” answers. For example, in regard to the first question, the fact that the foreign group member has no CEO conducting its day-to-day trade or business from a foreign office is an important requirement of the regulations. As for the second question, the answer generally will be “yes” where a foreign corporation's U.S. office actively participates in solicitation, negotiation, or performance of other significant services necessary for the consummation of a sale.  

Regarding the third question, where the foreign group member is making sales of inventory property for use, disposition, or consumption inside the United States, then all such income will be U.S.-source and therefore ECI. On the other hand, where the foreign group member is making sales of inventory property for use, disposition, or consumption outside the United States, it is necessary to examine for each sale what part, if any, the foreign group member’s foreign office played in making the sale and whether that part is significant enough to satisfy the material-participation requirement. If it does satisfy the requirement, then the answer to the third question is “no,” and the relevant sales income will be foreign-source and therefore not ECI. If the material-participation requirement is not met, then the answer is “yes,” and the relevant income is U.S.-source and ECI.  

In brief, if the foreign office “actively participates in soliciting the order resulting in the sale, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and buyer,” then the requirement will be met (Reg. Sec. 1.864-6(b)(3)(i)). Under the above assumptions, neither the foreign group member nor its DRE subsidiaries are performing any of these functions.  

Suppose that the DRE subsidiaries do maintain some local warehousing and perform some customer support functions. Will that be sufficient to meet the material-participation requirement? A detailed review of actual activities conducted by the DRE subsidiaries would, of course, be necessary. However, the likely answer is that the activities would not be sufficient. Under U.S. tax regulations, a foreign office will not be considered to have materially participated in a sale merely because (1) the sale is made subject to the final approval of the foreign office, (2) the property sold is held in and distributed from the foreign office, (3) samples of the property sold are displayed (but not otherwise promoted or sold) in the foreign office, (4) the foreign office is used for purposes of having title to the property pass outside the United States, or (5) the foreign office performs only clerical functions incident to the sale. Considering this, the local warehousing from which deliveries are made by the DRE subsidiaries will not constitute material participation. Whether the customer support functions might be significant enough to achieve material participation for some or all of the sales would require a careful review.  

Production income
Assume that a foreign group member has entered into a cost-sharing agreement with, or has licensed certain intellectual property from, a related U.S. group member so that the foreign group member holds the rights to manufacture or have manufactured certain products for sale outside the United States. The foreign group member has no employees or offices of its own but rather has service agreements with one or more U.S. group members under which personnel of these entities operating from within the United States control all arrangements with related and unrelated contract manufacturers. The various contract manufacturers conduct their product manufacturing services at their facilities both within and outside the United States.

Through the efforts of these U.S. group members’ personnel, the foreign group member enters into contract manufacturing agreements with these related and unrelated contract manufacturers and acquires directly from them the finished products that it sells to its customers. The related U.S. group members are neither a party to any of the foreign group member’s contract manufacturing agreements, nor do these related U.S. group members take title to any products produced by the contract manufacturers for sale to the foreign group member. (The related U.S. group members may enter into their own contract manufacturing agreements with these same contract manufacturers and acquire the products directly from them for sale within the United States.)

Because the discussion in this section focuses solely on production income, it is assumed that the foreign group member, through its DRE subsidiaries, controls and maintains relationships with all distributors and customers outside the United States, with DRE personnel negotiating the terms of the sales contracts. The DRE subsidiaries also maintain local warehousing and perform customer service functions from their various locations around the world.

Finally, assume that the foreign group member, because of the agency activities performed by the related U.S. group members on the foreign group member’s behalf, has met the above-mentioned threshold test of being engaged in a trade or business within the United States.

As indicated earlier, certain U.S. tax rules define the source of different types of income. Where a foreign group member has met the test of being engaged in a trade or business within the United States, all of certain types of income, including production income, to the extent they are U.S.-source, will be ECI subject to tax.

Rarely, if ever, will a foreign group member directly conduct production activities within the United States in its own name. However, sometimes U.S. group member employees conduct critically important functions for related foreign group members that may be sufficient to constitute manufacturing. U.S. tax regulations recognize that even if a company does not itself conduct physical manufacturing operations, it still may be treated as a manufacturer if it performs certain functions to direct a contract manufacturer that performs the physical manufacturing. (See Regs. Sec. 1.954-3(a)(4) concerning the manufacturing exception from foreign base company sales income treatment under the Subpart F controlled foreign corporation (CFC) rules.) The IRS added this recognition of contract manufacturing business models to the regulations within the past decade to modernize them and take into account what has now become a common business model.
While there has been no similar modernization of the relevant income sourcing and ECI regulations as yet, the concept that a company can be a manufacturer even though it does not itself conduct physical manufacturing should apply as well to the characterization of activities performed for sourcing of income and ECI purposes. The modernized regulations for Subpart F list the following functions (Regs. Sec. 1.954-3(a)(4)(iv)(b)) that will allow a company to be considered a manufacturer when it uses a contract manufacturer for the physical manufacturing:

- Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed;
- Material selection, vendor selection, or control of the raw materials, work-in-process, or finished goods;
- Management of manufacturing costs or capacities (e.g., managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs);
- Control of manufacturing related logistics;
- Quality control (e.g., sample testing or establishment of quality-control standards); and
- Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.

Where an IRS examination determines that any related U.S. group member performs these functions as an agent for the foreign group member, the IRS may reasonably conclude that the foreign group member is manufacturing inventory property in the United States. Note in this regard that the location of the contract manufacturer is not relevant. Rather, what matters is where the related U.S. group member performs these various listed functions. As such, even where the physical manufacturing is performed outside the United States, if the functions are performed by the U.S. group member within the United States, then the manufacturing is considered to be taking place in the United States.

Say that an IRS examination determines that the foreign group member is manufacturing its inventory property within the United States and selling the finished property outside the United States. For those transactions, half of the income would likely be attributed to the production activity in the United States and half to the sales activity occurring outside the United States. In such a case, the half attributable to the production activity in the United States is U.S.-source and ECI. The other half would be foreign-source and escape ECI treatment.

Although this latter one-half would escape ECI treatment, for any foreign group member that is also a CFC under the Subpart F rules, the manufacturing branch rule described in Regs. Sec. 1.954-3(b)(1)(ii) may apply to cause this latter one-half to be foreign base company sales income. If so treated, then it would be included immediately within the U.S. tax return of its U.S. shareholder.
**Services income**

Assume that a foreign group member earns services income from an internet-based business. The group of which the foreign group member is a part maintains an extensive online presence through which it provides cloud application services to paying customers and earns commissions from the sale or rental of third-party-owned digital products including applications, music, movies, books, etc. In addition, the group provides users around the world with certain free services and earns advertising revenues from clients wanting to connect with and display ads to these users.

The group personnel in the United States primarily performed the extensive work to create the group’s online presence, including design, software architecture, and coding, under a cost-sharing agreement that spread the costs among various group members, including the foreign group member. The foreign group member’s share of costs reflects its future anticipated benefits from income it expects to earn from services provided in its market area, which, for example, is defined as Europe and Africa. Ongoing management and further development, enhancement, maintenance, protection, and exploitation of the group’s online presence are performed primarily in the United States, with the various costs being shared among the group’s members under either the cost-sharing agreement or separate service agreements. Even though the foreign group member has no employees or offices of its own, it does own several DRE subsidiaries that conduct local marketing and liaison support for the group’s online presence and provide, on an as-needed basis, support for local customers and users. These subsidiaries also either own or secure from third-party providers the servers used by local customers and users to access the group’s online offerings.

Assume further that certain activities performed for the foreign group member by the related U.S. group members under service agreements amount to the exercise of agency powers, satisfying the above-mentioned threshold test of being engaged in a trade or business within the United States.

As indicated earlier, certain U.S. tax rules define the source of different types of income. Where a foreign group member has met the test of being engaged in a trade or business within the United States, all of certain types of income, including services income, will be ECI subject to tax, to the extent they are U.S.-source.

Certain income earned by a foreign group member could be U.S.-source services income and therefore ECI. For example, assume the foreign group member earns services income in the form of fees and commissions from:

- Cloud services performed for customers in its market area;

- The sale or rental of third-party digital products to purchasers in its market area; and

- Advertising directed toward users of the free services located in the market area.

To determine the source of this services income, it is necessary to ask where the foreign group member has performed these services.
Assume that the foreign group member does conduct some physical activities within its market area through its DRE subsidiaries that are clearly important to the foreign group member’s business. These activities, however, represent for the most part either marketing or as-needed support provided to a very limited number of customers or users. These services are really auxiliary in nature and do not represent the actual performance of the service for which the foreign group member is earning its services income.

The particular nature of cloud applications, third-party digital product sales/rentals, and advertising based on a platform regularly accessed by an extensive user base is relevant. In virtually all cases, the services that the foreign group member provides are supplied mechanically through the group’s various internet-based platforms and infrastructure. Seldom will any actions be required by locally based DRE subsidiary personnel that are actually the performance of services.

Considering all of this, it seems reasonable for the IRS to view the creation and ongoing management of the online platform, along with continuing development, enhancement, maintenance, protection, and exploitation, as the activities that generate the services income. Although the foreign group member is not itself performing any of these activities, it does receive the benefit of them and is bearing its share of their costs through both the cost-sharing agreement and the services agreement it has with its related U.S. group members, under which, as noted earlier, these companies exercise agency powers for the benefit of the foreign group member.

Finally, the use of a cost-sharing agreement that covers the platform creation and ongoing development, enhancement, etc., of it causes the foreign group member to be characterized for tax purposes as having directly created its share of the intangibles developed under the cost-sharing agreement (see Regs. Sec. 1.482-7(j)(3)). This means that the foreign group member is treated as directly conducting these activities within the United States, to the extent that the related U.S. group member cost-sharing agreement participants conduct them in the United States.

The clear and simple conclusion is that the foreign group member is earning services income primarily through activities performed in the United States. This would result in U.S.-source services income taxable as ECI.

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