

Offshore Migration of U.S. Intellectual Property: An Unintended Effect of Transfer Pricing Regulations

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The current U.S. tax system may be motivating American companies to move intangible assets offshore. The transfer pricing regime, which is well established in both U.S. and foreign law, seeks to avoid tax arbitrage by requiring payment of “arm’s-length” prices when assets are transferred between parties under common control.¹ In the U.S., enforcement of transfer pricing policies has become especially zealous with respect to intellectual property, chiefly because intangible assets are by their nature difficult of valuation, and also because undervaluation of high-profit intangibles has been an historical problem. Today, for taxpayers who would develop software, pharmaceuticals, or technology for worldwide distribution, the expense and uncertainty of compliance with transfer pricing regulations have become significant disincentives.

Intangibles, however, are unique in being easily moved between jurisdictions. Owners of valuable intangibles are induced to avoid U.S. taxation of sales to foreign customers by migrating the property offshore. While the transfer pricing regulations tend to deter this migration by requiring

fair-value payment for the property, the cost sharing arrangement, a device sanctioned by the regulations since 1968, provides a practical method to circumvent that requirement.

Many U.S. companies are now entering into cost sharing arrangements for the development of intangibles. The unintended result is that foreign corporations command increasing ownership of high-value intellectual property rights — rights which otherwise would be held in the U.S. This result may be expensive for the United States, in lost tax revenues and more importantly, in the decline of the nation’s historical leadership position in the development of software, medications, and technology.²

U.S. tax incentives designed to promote investment in research and development may magnify the concern. Current U.S. law offers both immediate deduction of research expenses and tax credits for technological research leading to new discoveries. These research incentives interact with the transfer pricing regime, and with the availability of cost sharing arrangements, to encourage migration: U.S. corporations will be motivated further to invest in

technology for development within U.S. borders, but for foreign ownership.

Offshore migration of intangibles results from incentives that are unwittingly established by the complex interplay of several factors. The key motivator is the breadth of the U.S. taxation system, which is unique in taxing its citizens on worldwide income. Only apocalyptic changes in the tax system will remove that motivator. In the short term, however, relatively simple remedies would encourage U.S. companies to retain full ownership of intellectual property. The Treasury should consider moderating the transfer pricing regulations with respect to intangibles, while strengthening the regulation of cost sharing arrangements.

I. Factors Motivating Offshore Migration

In the development and international sale of intellectual property, tax motivations are not straightforward. Rather, a complex tax landscape results from the interplay of four key factors: (1) the transfer pricing regime; (2) the unique economic characteristics of intangibles; (3) the special regulation of cost sharing arrangements; and (4) the availability of research tax incentives. As will be shown, the net effect of these factors will sensitively depend on the particulars of each taxpayer and each research project. As a general trend, however, it is clear that these factors unwittingly coalesce

¹Section 482, U.S. Internal Revenue Code.

²Currently, U.S. manufacturers account for nearly half of the major pharmaceuticals marketed worldwide, while the U.S. share of the world market for software is 44.7 percent. U.S. Reporter Industry Analysis, 20 January 2002 available at http://www.activemedia-guide.com/pharmaceutical_industry.htm.

to motivate migration of intangibles to foreign owners.

A. The Transfer Pricing Regime

U.S. citizens, resident aliens, and U.S. corporations are subject to U.S. taxes on their worldwide income. In contrast, many foreign countries impose taxes only on income from sources within their own borders. As a result, absent any mitigating controls, a U.S. taxpayer that has income-producing assets from various countries worldwide would be motivated to contribute the assets to a foreign corporation — one that the taxpayer controls. In doing so, most of the income that is generated from the asset would escape current U.S. taxation, and much of it might escape taxation in the foreign country as well. For example, assume DC contributes assets to FC, a subsidiary incorporated in country x. The property produces income from country x and county y, as well as from the United States. It is likely that the U.S. income will be taxed in the U.S., the county x income will be taxed in country x at a lower rate, and the county y income will not be taxed at all. If the foreign subsidiary is domiciled in a low-tax jurisdiction,³ the tax savings from this scheme could be significant.

As part of a complex system⁴ to mitigate this tax avoidance, the United States, like many other countries,⁵ has developed a transfer pricing regime, which applies to transactions between related parties. The regime is embodied in section 482 of the Internal Revenue Code and its accompanying regulations. When property is transferred between related parties, the regulations will require that the transferor be deemed to receive, as taxable income, the arm's-length value of the property that it transferred.⁶ The tax on the deemed income will obviate any tax advantage in making the transfer, but will not, in theory at least, discourage

transfers made for bona fide business reasons.

For the transfer pricing scheme to work well, the arm's-length value of transferred assets must be determinable with reasonable accuracy. If the value of outbound property is underestimated, taxpayers will still be motivated to move the property offshore, and tax avoidance will continue to be significant. Conversely, if its value is overestimated, developers will be artificially motivated to avoid offshore exploitation of their assets; if they do so anyway for business reasons, they will be unfairly overtaxed.

A cottage industry of lawyers and economists has grown to provide ostensibly accurate determinations of arm's-length values.

Lengthy and complex regulations⁷ attempt to provide consistent and predictable pricing of intellectual property transactions. The present value of the property is determined by using comparable transactions when they exist, arm's-length rates of return when comparables do not exist, and a profit-split approach when neither comparables nor arm's-length rates of return can be used to estimate intangible income.⁸ A cottage industry of lawyers and economists has grown to provide ostensibly accurate determinations of arm's-length values. Whether the system

produces accurate results is the subject of much debate, but most agree that the determination of fair values can mean expense and uncertainty for the taxpayer, and both the expense and the uncertainty will add to the cost of developing the new property, without adding to its quality, value, or marketability.

B. Unique Characteristics of Intellectual Property

Intellectual property challenges the transfer pricing regime, both because it is readily movable and because it is difficult to value. The property itself is easily shuttled across borders, and many intangibles, in a real sense, do not exist in

³Bermuda and the Cayman Islands often serve to provide such low-tax jurisdictions. See Johnston, David Cay, "U.S. Corporations Are Using Bermuda to Slash Tax Bills," *The New York Times*, 18 Feb. 2002, p. 1, Col. 3.

⁴Some other elements of the system include subpart F controls on controlled foreign corporations, sections 951-964, the passive foreign investment company rules of sections 1291 *et seq.*, the foreign personal holding company rules of section 1298, and the foreign investment company rules of section 1246.

⁵This requirement for arm's-length compensation between related parties is not unique to U.S. law, but represents an international norm. See for example section 247 of the Canadian Income Tax Act, the OECD Model Tax Treaty (OECD Committee on Financial Affairs, Paris, 1992), and the U.N. Model Tax Convention (United Nations Department of Economic and Social Affairs, Tax Treaties Between Developed and Developing Countries, Third Report (New York: United Nations, 1972)). See also the Treasury White Paper, Notice 88-123, *A Study of Intercompany Pricing Under Section 482 of the Code* (July 1988), at p. 93; and Li, Jinyan, "Slicing the Digital Pie With a Traditional Knife — Effectiveness of the Arm's-Length Principle in the Age of E-Commerce," *Tax Notes Int'l*, 19 Nov. 2001, p. 775, 2001 WTD 239-28, or Doc 2001-30439 (30 original pages).

⁶Income Tax Regulations, 1.482-4.

⁷Income Tax Regulations, 1.482-1 *et seq.*

⁸Treasury White Paper, *ibid* note 5, at p. 2.

any particular place.⁹ The resources usually required for development of most intellectual property — research libraries, educated personnel, and computers — are also relatively movable. Unlike more traditional assets which may be tied to warehouses, mineral deposits, or factories, intellectual property can be readily relocated to jurisdictions of choice. Developers of intangibles are hence particularly likely to respond to tax incentives. Incentives to move property offshore will more readily affect intangibles than tangible property.

Intellectual property is notoriously difficult to value, especially early in its useful life.¹⁰ The special characteristics of intellectual property make it uniquely adverse to clean application of transfer pricing principles, and the application of the section 482 transfer pricing methods to determine arm's-length value will yield uncertain results, at best. Both the Congress¹¹ and the Treasury¹² have often recognized this problem. Sources of difficulty in the valuation of intellectual property include the following:

Absence of Comparable Transactions. Most intellectual property is, in essence, a legal monopoly. Both patents and copyrights, for example, confer on their owners the exclusive right to exploitation of the protected ideas or expressions. As a result, there are rarely “comparable” transactions in the marketplace that would serve as a meaningful guide to value. Moreover, transactions in intellectual property are often structured, for business reasons, between controlled parties in ways that would never be acceptable between parties dealing at arm's length.¹³ This further reduces the availability of comparables. As all transfer pricing systems must, the section 482 regulations rely heavily on comparable valuation to determine the value of property. The regs recognize the exceptional nature of intellectual property and provide several alternative

methods for valuation,¹⁴ but none of these is as effective as direct comparables would be, if they existed.

Short Useful Life. Intellectual property often has a short useful life. New software, for example, may have commercial value only for the few months before it is eclipsed by a newfangled, competing technology. The useful life of any given property may be difficult to determine, and therefore, its present value will be ephemeral even if its periodic value can be ascertained.

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High-Risk Nature. Development of intellectual property in all areas is essentially high risk, and there is no consistency in the ratio between dollars invested and the potential return on investment. Research in intangibles, like research generally, is highly speculative, and income from successful developments must bear the cost of many unsuccessful ones.¹⁵

Jurisdictional Variation in Value. Since legal regimes for protection of copyright, patents, and trade secrets vary significantly between countries, any given intellectual property may have a high value in one place and low value in another; intellectual

property does not readily retain its value when crossing international borders.

Recognizing that the value of intangible property is most accurately determined in hindsight, Congress added the “Super-Royalty” provision to the code as part of the Tax Reform Act of 1986. The provision was codified as amendments to section 482, and to section 367(d).¹⁶ These sections backstop the arm's-length standard with respect to intangible property by requiring that the consideration paid by a related party for such property be “commensurate with the income attributable to the intangible.” The data available to establish arm's-length compensation hence

⁹Intangibles often represent concepts or expressions which are protected by law and which may derive their value partially or completely from that legal protection. In that sense, the intangibles are tied to the jurisdictions that protect them. However, as a practical matter, most intangibles, once conveyed to the customer, are useful and valuable regardless of location. Intangibles in the form of software are valuable only in conjunction with a physical machine, but the machines themselves are ubiquitous, and the software can be moved by wire, wireless, or satellite without moving the machine.

¹⁰The OECD notes that intangible property's special character complicates the search for comparables and makes the value difficult to determine at the time of the transaction. OECD Report: *Transfer Pricing and Multinational Enterprises* (1979, revised 1995).

¹¹H.R. Conference Report, No 841, 99th Congress, 2d Session, II-638 (1986).

¹²Determination of the arm's-length price of an intangible routinely requires employment of international tax experts and economists. See the Treasury White Paper at p. 40, *et seq.*

¹³OECD Guidelines, *op. cit.*

¹⁴Reg. section 1.482-4(a). The comparable profits method 1.482-5 and the profit split method 1.482-6 are specifically delineated.

¹⁵See the regulations regarding research expenditures at 1.861-17(a)(1).

¹⁶The super-royalty also applies to the cost-sharing election available to U.S. possessions corporations, see section 936.

extends beyond the information known at the time of the transfer, but include the property's later "actual profit experience."¹⁷ Compensation must be adjusted over time to reflect changes in income attributable to the intangible.

From the taxpayer's point of view, these regulations present uncertainty and the ongoing anxiety that taxes associated with a particular transaction may unpredictably increase over time. As a result, taxpayers are motivated to seek alternatives that will insulate them from such redeterminations by the Service, and which will avoid the expense and uncertainty of determining arm's-length values of their intangible property.

C. The Cost Sharing Arrangement

Regulations finalized¹⁸ in 1995 provide such an alternative. Under a cost sharing arrangement, the recipient of an interest in intangible property is not required to pay an arm's-length royalty for its use; it need only bear an appropriate share of the costs of the research relating to its development. For domestic taxpayers wishing to transfer intellectual property for exploitation abroad, the cost sharing arrangement provides a device to avoid deemed royalty income (and its associated tax), and also avoid the expense of determining the arm's-length price of the intangible.¹⁹

Cost sharing arrangements have existed for decades.²⁰ Congress, in amending section 482 as part of the Tax Reform Act of 1986, expressed approval of cost sharing arrangements,²¹ provided that they would produce results consistent with the "commensurate with income" standard. To do so, Congress recommended several requirements, which generally have been since incorporated into regulations adopted in 1995. These regulations (codified as section 1.482-7, the "dash seven regs") allow the taxpayer using a cost

sharing arrangement to avoid application of the transfer pricing methods.²² If a cost sharing arrangement qualifies under the regs, section 482 does not apply to allocate royalties or arm's-length payments. More importantly, the taxpayer is insulated from the Service's subsequent determination of deemed royalty income.²³ Instead, the Service can modify the parties' agreement only to adjust the allocation of costs between the parties, to accurately reflect the parties' respective proportional expected benefits from the covered intangible.²⁴

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Under a cost sharing arrangement, two or more parties²⁵ agree to share research and development costs, in exchange for an ownership interest in the intangibles that are developed through the association. The parties share the costs and risks of development in proportion to their anticipated benefits from development.²⁶ The agreement to share costs will usually require one participant to settle up with the others. These payments to reimburse costs incurred are generally treated as a repayment of loans. If such a payment is made to a domestic corporation (DC), the payment is not treated as income, but instead

reduces the amount of deductions otherwise allowable.²⁷ If the

¹⁷H.R. Rep. No. 426, 99th Cong., 1st Sess. 425-26 (1985). Regs. 1.367(d)-1T(c).

¹⁸The substantive regulations were issued on 19 December 1995, T.D. 8632; technical amendments were issued 9 May 1996, TD 8670, corrected 27 June 1996. The regulations are effective for tax years after 31 December 1995.

¹⁹See note 12 *infra*.

²⁰Carvey, Hannah and Picciano, Kenneth, "Final Regs Clarify Cost Sharing of R&D Expenditures," 1-97 *The Tax Advisor* 27 (January 1997). Ironically, the visibility and popularity of cost sharing arrangements as a tax planning vehicle may have been increased by the 1988 White Paper from the U.S. Treasury and its ensuing commentary.

²¹H.R. Conference Report, No. 841, 99th Congress, 2d Session, II-638 (1986).

²²26 C.F.R. 1.482-4, 1.482-7. See also Carvey and Picciano, *op. cit.*

²³Income Tax Regulations, section 1.482-7(a)(2), provides: "The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs . . . equal to its share of reasonably anticipated benefit." Under a cost sharing arrangement that meets the formal requirements of the regulations, the Service's review is generally limited to what products are included in the cost sharing arrangement, the cost of development of those products, and how those costs are shared among the participants. Levey and Garafalo, note 70 *infra*.

²⁴Income Tax Regulations, section 1.482-7(a)(2).

²⁵Cost sharing arrangements may exist between unrelated parties, but they suggest significant tax issues only as between parties who are related.

²⁶The cost sharing arrangement differs from traditional licensing, in that no royalties are due from the participants to each other. At the same time, the cost sharing arrangement does not form a partnership, and the parties are not required to pool profits or share a profit interest. A foreign entity will not, by virtue of the cost sharing arrangement alone, create a permanent establishment in the United States. Income Tax Regulations, section 1.482-7.

²⁷Internal Revenue Code, section 936(h). See Treasury White Paper at p. 223. The forfeiture of deductions by the domestic corporation can represent a significant tax cost, since income is now fully taxed, which otherwise would have been offset by the deductions.

payment is outbound to a foreign participant, no U.S. withholding tax is imposed.²⁸

In comparison to the general transfer pricing regulations that would otherwise apply, the “dash seven” regulations that govern cost sharing arrangements are not as rigorous or as exacting. The dash seven regulations offer two key advantages to the taxpayer: the avoidance of deemed income under the super-royalty provisions, and the limitations on the Service’s ability to redetermine tax.

Avoiding Deemed Income Under the Super-Royalty Provisions. The transfer pricing regulations generally provide that intellectual property is not shifted between related parties without appropriate *income* to the transferee, and the Service will deem income to exist if the property proves to be more valuable than expected. By contrast, the dash seven regulations instead require that *development costs* of intellectual property are not shifted between related parties, except in proportion to *expected benefit*; if actual benefits are not as expected, the Service may adjust the *costs* but will not otherwise deem income to exist. In determining the cost allocations, the Director must look to the reasonability of anticipated benefit shares at the time of the cost sharing arrangement, not the actual benefits received as viewed in hindsight.²⁹ Nevertheless, if the actual benefits diverge from anticipated benefits by more than 20 percent, the Director may find that the anticipated benefits were unreasonable.

Limited Remedy. Where there is a qualified cost sharing arrangement, the Treasury’s remedies are limited to review and correction of the ratio of cost sharing, and the scope of costs included.³⁰ The regulations³¹ specifically provide that the Service may not make allocations with respect to cost sharing arrangements, except to the extent necessary to comply with the anticipated benefit requirement, explained below.

There is no power to deem that royalties have been paid or to set the amount thereof. Nevertheless, the Service may refuse to recognize a qualified cost sharing arrangement at all, and it has recently done so whenever there is even only technical noncompliance with the administrative provisions of the dash seven regulations.³²

D. Research Tax Incentives

Taxpayer motivation to employ a cost sharing arrangement is influenced by two research tax incentives provided for by the Internal Revenue Code: current deductibility of research and experimental expenditures under

The allocation of research deductions abroad under the U.S. sourcing rules can have the effect of reducing foreign-source taxable income, without reducing the taxes imposed by foreign jurisdictions.

section 174, and the credit for increasing research activities under section 41.

1. Expensing of Research and Development Expenditures

Section 174 provides for the current deductibility of research and development costs,³³ which otherwise might have to be capitalized.³⁴ The scope of eligible costs is fairly broad,³⁵ and even costs for development of products that are unrelated to the taxpayer’s existing product line can be expensed under section 174.³⁶

A taxpayer will generally prefer that research costs, if they fall

within the ambit of section 174, be incurred in the United States, so that the taxpayer may take full advantage of current deductibility. If the product is developed for both U.S. and foreign distribution, sourcing rules will require the domestic taxpayer to allocate a portion of the costs abroad.³⁷ This will have the negative effect of reducing foreign-source income, and hence constraining the taxpayer’s access to foreign tax credits by reducing the upper limitation provided by section 904.

Foreign laws may also allow deductions for research and development, but usually only if the research is actually performed within the foreign jurisdiction.³⁸ Thus, the allocation of research deductions abroad under the U.S. sourcing rules can have the effect of reducing foreign-source taxable

²⁸Treasury White Paper at p. 223.

²⁹Income Tax Regulations, section 1.482-7(f)(3)(iv)(B).

³⁰Issues of scope have become controversial. See section III, *infra*.

³¹Reg. 1.482-7(a)(2).

³²Internal Revenue Service Field Service Advice, FSA 200009022 (30 Nov. 1999).

³³Deductibility of development costs is well treated by Petry, Marvin, *Taxation of Intellectual Property*, Matthew Bender, field release 29 (2001), Chapter 3.

³⁴The extent to which the *INDOPCO* case may require capitalization of such costs is not yet ascertained. *INDOPCO v. Commissioner* 503 U.S. 79 (1992).

³⁵Income Tax Regulations 1.174-2.

³⁶*Snow v. Commissioner*, 416 U.S. 500 (1974).

³⁷Section 864(f) enacted 1993; reg. section 1.861-17(g). The current requirements are the result of a complex history during which the percentage allocations varied considerably. The current statute indicates that a portion of the research costs is allocated to the situs where actually performed, the remaining are allocated in proportion to either sales or gross income.

³⁸Bittker, *Fundamentals of International Taxation*, pp. 73-84.

income, without reducing the taxes imposed by foreign jurisdictions. This in turn can cause the foreign tax credit limitation of section 904 to be less than the taxes actually imposed.

Independent of the effect of transfer pricing, domestic taxpayers are encouraged to move their research activities abroad, as this would serve to bring their foreign taxes in line with their foreign-source income.³⁹ The employment of cost sharing arrangements between U.S. or U.S. possession affiliates⁴⁰ will not alter this effect, since affiliated corporations allocate costs and apportion section 174 deductions as though they were one corporation.⁴¹ However, use of a cost sharing arrangement with a foreign subsidiary⁴² can restrict the availability of section 174 deductions. In that case, cost sharing reduces the R&D expense of the taxpayer to the extent allocated to foreign participants. This will increase taxable income to the domestic taxpayer.⁴³

2. Tax Credit for Increasing Research Activities

Section 41 of the Internal Revenue Code provides a 20 percent credit for increases in expenditures for scientific and technological research.⁴⁴ The credit is available only for research conducted in the United States.⁴⁵ The scope of its application is narrower than that of section 174.⁴⁶ Under the "discovery test," the section 41 credit is available only for research undertaken for the purpose of discovering information which is "technological" in nature,⁴⁷ and which exceeds, expands, or refines the common knowledge of skilled professionals. In addition, the discovery must be useful in the development of a new or improved business component of the taxpayer. In general, only research in the early stages of development will qualify; expenses in testing and preparing a product for market will not qualify, nor will most costs incurred after development of a commercially viable

model.⁴⁸ For taxpayers whose research falls within the definition, section 41 will provide some motivation to keep the qualifying research in the United States.

The use of cost sharing arrangements will not affect the availability of the section 41 research credit, provided the research is actually performed in the United States. Under regulations specific to the credit, members of a commonly controlled group of corporations may disregard inter-company reimbursements.⁴⁹ Hence, a U.S. company that performs qualifying research is treated as incurring all of the research expenses for purposes of calculating the section 41 research credit, even if the domestic company is reimbursed for a portion of those expenses under a cost sharing arrangement.

II. How Tax Motivations Drive Intangibles Offshore: An Example

Given the unique qualities of intangibles, a complex tax landscape results from the interplay of the transfer pricing regime, and its special cost sharing arrangement rules, with the research tax incentives. That this tax landscape catalyzes the migration of intangibles offshore is best demonstrated by example. Consider the position of a U.S. domestic corporation (DC) which has developed some intellectual property that it believes, with further development, will produce products of value both to U.S. and foreign customers.⁵⁰ It now has at least three options.

A. U.S. Development

DC can invest in further refining the technology, and then sell the resulting product directly in the U.S. and abroad. The sales proceeds will be fully subject to U.S. taxation, even as regards sales to foreign customers.⁵¹ The proceeds normally will represent ordinary income.⁵²

The research may be eligible for the benefits of the research tax

incentives. If the research falls within the somewhat narrow requirements of section 41, the tax credit may provide a significant

³⁹See HR Rep No 247, 101st Congress, 1st Session, 57 (1989).

⁴⁰Income Tax Regulations, section 1.861-14T(d).

⁴¹Income Tax Regulations, section 1.861-17(a)(3).

⁴²Foreign corporations cannot qualify as "includable" corporations in an affiliated group under section 1504(a) and therefore are not treated as one corporation with the domestic taxpayer under 1.861-17(a)(3).

⁴³Hardesty, *op. cit.*, Carvey & Picciano, *op. cit.*

⁴⁴See Petry, *op. cit.*, Chapter 9.

⁴⁵Section 41(d)(4)(F). For this purpose U.S. possessions and Puerto Rico are within the United States.

⁴⁶Reg. section 1.41-1(a): "the credit is not available merely because the expenditure may be treated as an expense under Section 174." Reg. section 1.41-4(a)(2) requires that the expenditure must be a section 174 expense to be eligible for the credit under section 41.

⁴⁷Section 41(d)(1)(B); proposed regulation 1.41-4(a).

⁴⁸Petry, *op. cit.*, pp. 9-15.

⁴⁹Income Tax Regulations, sections 1.41-8(e), 1.482-7(a)(1). See also Treasury White Paper, footnote 239; see also Letter Ruling 9511011.

⁵⁰Similar but not identical dynamics govern the position of a foreign parent that creates a U.S. subsidiary.

⁵¹With some planning, DC may be able to "source" abroad the income from foreign customers, depending on where title will pass, and depending on the nature of the property. This will not reduce DC's taxable income, but may invoke foreign taxes on the income, which could then be offset by a foreign tax credit from the U.S. Whether this is beneficial will depend on what other foreign income the company has and the relative cost of sourcing the transaction offshore. However, in the normal case the effective tax rate will not drop below the ordinary U.S. rate, due to the limitation on foreign tax credits imposed by section 904.

⁵²Whether characterized as gain on the sales of inventory or as royalties, the proceeds from the sale of intellectual property generally produce ordinary income. If the property produces property other than inventory for sale to customers in the ordinary course, the gains may qualify as capital gains, in which case a reduced tax rate may apply.

advantage. If the research meets the (relatively less arduous) requirements of section 174, the taxpayer will be able to deduct these costs in the current year, although it may have to allocate a portion of them against foreign income.⁵³

B. Foreign Development

DC can transfer the partially developed intellectual property to a new or pre-existing subsidiary corporation created under foreign law (FC), either as a capital contribution,⁵⁴ or in exchange for royalties. If the transfer is made as a capital contribution, DC will be deemed to recognize as income the market value of the intangibles.⁵⁵ If the transfer is in exchange for royalties, the adequacy of the royalty payments will be subject to ongoing review under the transfer pricing regulations.

If DC has excess foreign tax credits, the actual or deemed sale to FC of the intellectual property for arm's-length royalties will have the beneficial effect of creating foreign-source royalty income, often taxed at low rates. This will increase foreign income under the "general" basket of section 904,⁵⁶ and increase the upper limit on the foreign tax credit available to the domestic taxpayer.

Whether DC sells or contributes the property to FC, the valuation of the intangibles must fairly reflect the future royalty stream to be earned from the property.⁵⁷ If the technology later proves successful, the determined value of the intangible may be retroactively adjusted,⁵⁸ in which case DC will be subject to additional taxation. DC is likely to incur substantial legal and consulting costs to determine the value of the property and to comply with the transfer pricing regulations.

By having FC incur the expenses of research, DC may also lose the benefit of deducting research expenses; if the research is actually performed offshore, it will lose any research credit as well.

Once the product develops income, the subsidiary's proceeds from sales of the product offshore⁵⁹ will likely escape current U.S. taxation.⁶⁰ That income may be taxable by the foreign jurisdiction, especially as to income sourced within that country; the foreign tax rate may be substantially lower than U.S. rates. On the other hand, if it turns out that the technology is later unsuccessful, FC may suffer losses; DC may be limited in the extent to which these losses can offset DC's other income.⁶¹

C. Joint Development

DC may enter with FC into a cost sharing arrangement — a

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formal agreement jointly to further develop the technology and to share proportionately in the cost and benefits. DC may anticipate that it will exploit the developed property in the U.S., while FC will exploit the technology abroad. If DC anticipates that U.S. sales⁶² will represent x percent of the worldwide income from the property, it might agree to bear x percent of the total development costs. If DC contributes its partially developed intellectual property to the effort, it will be deemed to receive from FC the market value of that property (the

⁵³A portion of the research costs may have to be allocated to foreign income under section 864(f).

⁵⁴In the normal case the contribution will not be recognized as taxable income under section 351 or 361.

⁵⁵Section 367(d), enacted in 1984, provides that a transfer of intangibles to foreign corporations in an exchange described in section 351 or 361 is to be treated as a sale, with the transferor being treated as receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for annual payments contingent on productivity, use, or disposition of the property. Such payments are treated as reductions of the foreign entity's earnings and profits and as U.S.-source income to the U.S. recipient. See Treasury White Paper at pp. 202-203.

⁵⁶Carvey and Picciano, *op. cit.*

⁵⁷Section 482 specifically requires, under an amendment adopted in 1986, that consideration for intangible property be commensurate with the income attributable to it. Section 1231(e)(1) of the Tax Reform Act of 1986.

⁵⁸Income Tax Regulations, section 1.482-4, will require that the arm's-length price be adjusted so as to be commensurate with the actual royalties received from the technology by FC. This regulation was adopted in 1986 specifically to address the migration of "high-profit" intangibles to tax havens. See the Treasury White Paper at p. 75-76.

⁵⁹Sales to U.S. customers may be subject to U.S. taxation. In some situations, outbound payments from U.S. purchasers to foreign sellers may be subject to withholding at a 30 percent rate; treaties may reduce this rate or eliminate the withholding. See Internal Revenue Code section 871(a)(1)(d).

⁶⁰U.S. taxes may nevertheless be imposed on these proceeds in a number of circumstances, because laws other than the transfer pricing regulations also affect taxation of foreign entities. For example, the subpart F regime may impose taxes on FC's earnings as if they were earned by DC. If FC intentionally or inadvertently establishes a permanent establishment in the United States, some of its income may be subject to U.S. taxation. In any case, once earnings from the FC's operations are repatriated to DC in the form of dividends, such dividends generally will be fully subject to U.S. taxation.

⁶¹Loss limitation rules include section 904(f).

⁶²In a particular case, sales may or may not be the best measurement of benefit; gross revenues or gross profits may be better indicators.

valuation of which may be subject to some controversy).⁶³

Payments made under the cost sharing arrangement between FC and DC in reimbursement of the research and development costs are generally tax-free. Inbound payments from FC to DC will be treated as repayment of costs advanced, and not as royalties.⁶⁴ (Such inbound payments may be subject to foreign tax withholding in some jurisdictions.)⁶⁵ Any outbound cost sharing payments from DC to FC will not be subject to U.S. withholding taxes.⁶⁶

A taxpayer wishing to develop intangible property must weigh the potential benefits and burdens of employing a cost sharing arrangement. The main disincentive will likely be a reduction of section 174 deductions; to the extent such costs are shifted to FC, DC cannot expense those costs. A second significant disincentive might be the elimination of foreign-source royalties from FC, which, although they would be taxable income, would also increase the upper limit on foreign tax credits. A third disincentive is the risk that the development will not be commercially successful, in which case the tax planning will become detrimental; a portion of DC's losses will have been moved offshore and made unavailable, but no low-tax income will have been generated in compensation. Not all situations will motivate a cost sharing arrangement. In many cases, however, the key benefits, summarized as follows, will push toward a cost sharing arrangement.

Avoiding Royalty Income.

Perhaps the chief benefit of a cost sharing arrangement is that DC avoids royalty income from FC and so avoids the associated tax. This is doubly beneficial because DC also avoids the risk of subsequent deemed royalties being imposed by the Service under the transfer pricing regulations and the super-royalty provisions of sections 482 and 367(d). If the technology is successful, only the x percent of the income attributable to DC will

be subject to current U.S. taxation; the remaining income enjoyed by FC, or a portion thereof, may be taxable by the foreign jurisdiction, at perhaps much lower rates, and will not be currently taxable by the United States.⁶⁷

Research Tax Credit Unaffected.

Cost sharing arrangements seem designed to support research eligible for the section 41 credit. In a typical case, the cost sharing arrangement will provide that DC will perform most or all of the research within the U.S., and that DC and FC will share the cost; DC will retain rights to exploitation of the product in the U.S., but all

Use of a cost sharing arrangement reduces the taxpayer's risk that the Service will redetermine its tax liability under the transfer pricing regulations.

foreign rights will be granted to FC. Under such an arrangement, DC will enjoy in full the advantage of tax credits for research conducted in the United States, notwithstanding FC's absorption of a portion of the cost.

Reducing Compliance Expense.

By limiting the application of the transfer pricing regulations, the taxpayer reduces the often-significant expense associated with demonstrating an appropriate arm's-length price for the transferred technology. If there is a contribution of pre-existing technology under the cost sharing

arrangement, transfer pricing methodologies will still apply, and some expense will still be incurred. However, the scope of determining the value of existing intellectual property will likely be much narrower than determining the value of intangibles to be developed over time.

Reducing Compliance Uncertainty.

Use of a cost sharing arrangement reduces the taxpayer's risk that the Service will redetermine its tax liability under the transfer pricing regulations. Without the cost sharing arrangement, transfer prices associated with intangibles are always open to continuing review under the "commensurate with income" standard. With a cost sharing arrangement, the issues reviewed by the Service are limited to the valuation of any buy-in payment, and the allocations of development costs.⁶⁸

Status-Related Benefits. In particular situations,⁶⁹ offshore ownership of intangibles can increase the quantity of "active" assets held by a foreign affiliate. This in turn may assist the foreign

⁶³See subsection C, "The Buy-in Requirement" in section III, "Current Regulation of Cost Sharing Arrangements" *infra*.

⁶⁴Income Tax Regulations, section 1.482-7(h)(1).

⁶⁵The cost sharing payments received by DC from FC will not be foreign-source income to the U.S. entity. Instead, the payments reduce R&D expenses that would otherwise be deducted by DC, subject to allocation under 1.861-8. See Carvey and Picciano, *op. cit.*

⁶⁶Income Tax Regulations, section 1.482-7(h)(1).

⁶⁷Subject to the exceptions that (a) U.S.-source income may still be subject to taxation under section 871 or otherwise, and (b) dividends repatriated to the United States from FC to DC will be subject to taxation.

⁶⁸Income Tax Regulations, section 1.482-7(a)(2). See note 23.

⁶⁹See Carvey and Picciano, *op. cit.*

entity in avoiding “passive foreign investment company” status under section 956A. Similarly, the cost sharing arrangement can increase foreign sales corporation income by reducing the domestic parent’s research expenses.

Comparing the three examples demonstrates that, especially where section 174 expenses are low in comparison to potential offshore revenues, the joint development under a cost sharing arrangement may provide significant advantages. It will protect foreign sales from immediate U.S. taxation, while avoiding a significant deemed royalty to the domestic entity. If the taxpayer does employ the cost sharing arrangement, the unavoidable result is that at least partial ownership of the valuable property will rest offshore.

III. Current Regulation of Cost Sharing Arrangements

Because of their relatively less rigorous nature, the cost sharing arrangement regulations are accurately perceived by the Treasury⁷⁰ as a loophole in the fabric of the transfer pricing regime. Recent determinations of the Service suggest that the Service will enforce the dash seven regulations rather strictly.⁷¹

The current regulations operate generally to ensure that development costs are not shifted between the parties, except in proportion to expected benefits. Cost sharing arrangements are recognized only if “qualified.” If the agreement between the parties is not recognized as a qualified cost sharing arrangement, the agreement is ignored and instead the transfer of property is subject to the general regulations of the transfer pricing regime, which will likely result in deemed income to the domestic taxpayer.⁷² To be a qualified cost sharing arrangement, the arrangement must meet three key substantive requirements: (1) the “expectation of benefits” requirement; (2) the “anticipated benefits”

requirement; and (3) the buy-in requirements. In addition, the cost sharing arrangement must meet several administrative requirements, which are strictly enforced.

A. The ‘Expectation of Benefits’ Requirement

A party is eligible to enter into a qualified cost sharing arrangement only if that party reasonably expects to derive some benefit from the arrangement.⁷³ This would seem to implement the general concept that participants cannot shift costs between them without also shifting the associated income. However, the benefit need not be in the form of anticipated taxable

Because of their relatively less rigorous nature, the cost sharing arrangement regulations are accurately perceived by the Treasury as a loophole in the fabric of the transfer pricing regime.

income; it may also be in the form of reduced costs or other direct benefit to the participant,⁷⁴ as long as the benefit is reliably measurable.⁷⁵ The benefit is not required to emanate from the conduct of the participant’s active trade or business.⁷⁶

The reasonably anticipated benefit will normally accrue to the taxpayer through an exclusive assignment of rights in the resulting product.⁷⁷ If, for example, DC will perform research but will not enjoy the right to use or to sell the product — or if DC received only rights that are worthless as a

practical matter — then DC has no reasonably anticipated benefit and the cost sharing arrangement will not qualify.⁷⁸ Similarly, assignment to a controlled participant of less than exclusive rights in a geographic area may disqualify the cost sharing arrangement for want of anticipated benefit.⁷⁹

To qualify as a cost sharing arrangement each participant

⁷⁰As evidenced by the recent stream of decisions unfavorable to the taxpayer. See Levey, Marc, and Garafalo, William, “Recent FSAs Take a Hard Line on the Drafting of Cost Sharing Agreements,” 2001 WTD 104-19 or Doc 2001-14862 (9 original pages) (2 Mar. 2001): “The Service may view cost sharing arrangements as an area of abuse or a loophole in the transfer pricing area.”

⁷¹See Levey, *op. cit.*

⁷²Income Tax Regulations, section 1.482-4. The nonqualified cost sharing arrangement may also be recognized as a partnership agreement if it meets the requirements for a partnership under 301.4401-3(e). Qualified cost sharing arrangements avoid per se partnership status under 1.482-7(a)(1): “A qualified cost sharing arrangement . . . will not be treated as a partnership to which the rules of Subchapter K apply.”

⁷³26 C.F.R. 1.482-7(c). This regulation does not preclude the engagement of third-party contractors to perform development work, so long as risk and control remain with the taxpayer. 1.482-7(c)(2).

⁷⁴Reg. 1.482-7(e)(1) defined “benefits” as additional income generated or costs saved by the use of the covered intangibles.

⁷⁵Income Tax Regulations, section 1.482-7(c)(1)(i).

⁷⁶The “active business requirement,” initially included by the Treasury to backstop the expectation of benefits rule, was eliminated in the final regulations dated May 1996.

⁷⁷This may include the right of the taxpayer to exploit the product itself, for example in its own manufacturing process.

⁷⁸See Example 1, Income Tax Regulations, section 1.482-7. Where foreign subsidiaries enjoyed rights to exploit the property in their local jurisdictions and the domestic research subsidiary expected no benefits from the intangibles being developed, the Service found that the cost sharing arrangement was not qualified. FSA 200013010 (16 Dec. 1999).

⁷⁹Treasury White Paper, *op. cit.* note 5.

must engage in some business activity and assume some business risk. If a participant in a cost sharing arrangement does not expect substantial benefits but merely supplies research services, the better characterization is that the entity is an “assister” under the transfer pricing regulations, and the services rendered must be compensated at arm’s length; the cost sharing regulations of dash seven will not apply.

B. The ‘Anticipated Benefit’ Requirement

The cost allocations between participants under common control⁸⁰ must be proportional to each participant’s share of the reasonably anticipated benefits under the cost sharing arrangement. While this requirement refers to anticipated benefits at the time of the cost sharing arrangement, and not the actual benefits later, it is important to note that actual benefits may be considered in determining whether anticipated benefits were reasonable.⁸¹ If they were not, the Service may require that costs be shared proportionately with actual benefits.

The regulations prescribe several methods⁸² of determining reasonably anticipated benefits, which are analogous, but not identical, to the transfer pricing methods applicable more generally. Possible bases for measuring anticipated benefits include units to be used, produced, or sold; gross sales may be used as a basis if each controlled participant is expected to experience a similar effect on net profit per dollar of sales. Operating profits are the preferred measure when the intangible will be used to reduce costs, for example in improving a manufacturing process. Anticipated benefits must take into effect variations in timing of the benefit to each participant.

The cost sharing document must outline the method by which each party’s share of benefits will be calculated, and these benefits as calculated must be reasonably

anticipated. The “best method” for calculation must be used.⁸³ The Service recognizes⁸⁴ the difficulty of making this calculation, and is empowered to adjust the determination only if either (a) the “best method” for calculation was not used or (b) the anticipated benefit differs from actual benefit by more than 20 percent, but only if the divergence is not due to an “extraordinary event” beyond the control of the participants.⁸⁵ As a practical matter it may be very difficult for the taxpayer to measure the anticipated benefits. It is likely that projection of benefits will require projecting the underlying bases and the factors

The exact scope of the costs that may be or must be shared under a cost sharing arrangement has become an issue of some controversy.

contributing to those bases.⁸⁶ For example, projecting net profits will require projecting sales, cost of sales, and operating expenses, all of which will require projecting customer base changes, demand, and market conditions. Such projections are likely to be wildly speculative, even when projected from solidly reliable current information. Nevertheless, the regulations require that the cost sharing arrangement provide for annual adjustment to the cost shares to take account of changes in economic conditions, business operations, and ongoing development of the intangibles.⁸⁷ Despite

that difficulty, this projection requirement is less onerous than would be the super-royalty requirement,⁸⁸ which would apply absent the cost sharing arrangement.

The exact scope of the costs that may be or must be shared under a cost sharing arrangement has become an issue of some controversy. It is, for example, unclear whether marketing intangibles may be included as cost elements in a cost sharing arrangement.⁸⁹ The definition of costs in the dash seven regulations is broad, including all costs incurred by a participant related to the development of the intangible, net of cost sharing payments, whether or not deductible.⁹⁰ Because of the dynamics of the tax landscape described above, in most cases the

⁸⁰Participants not under common control with other parties are not considered for purposes of the anticipated benefit rule. Income Tax Regulations, section 1.482-7(f)(3)(i). As noted *supra*, participation of such parties does not normally present significant tax issues.

⁸¹Income Tax Regulations, section 1.482-7(f)(1).

⁸²Income Tax Regulations, section 1.482-(f)(3).

⁸³Income Tax Regulations, section 1.482-7(f)(3)(i).

⁸⁴Treasury White Paper, *op. cit.* note 5, at p. 215.

⁸⁵Income Tax Regulations, section 1.482-7(f)(3)(iv)(B).

⁸⁶See Income Tax Regulations, section 1.482-7(f)(3)(iv)(B).

⁸⁷Income Tax Regulations, section 1.482-7(f)(1).

⁸⁸The requirement that royalties paid periodically be annually adjusted to be commensurate with income. Income Tax Regulations, section 1.482-4(f)(2)(i).

⁸⁹The Treasury White Paper, *op. cit.* note 5, at Chapter 13, section C (1, 1988-2 CB 496) indicated that marketing intangibles should be excluded, but no such exclusion is contained in the final regulations.

⁹⁰Income Tax Regulations, section 1.482-7(d)(1). Conversely, deductible but noneconomic expenses such as amortization and depreciation expenses are not costs to be shared under the cost sharing arrangement.

taxpayer will be motivated to include costs domestically incurred and to exclude costs incurred by the foreign entity. However, as to costs that are not deductible under U.S. law, the opposite motivation may exist. In a much-publicized and much-criticized ruling,⁹¹ the Service determined that the fair market value of stock options granted to employees of the domestic corporation, who performed R&D under a cost sharing arrangement, must be included in the cost sharing pool of expenses. This presumably would require that the DC be paid by the FC for additional costs incurred, although it is unclear that such payment is subject to taxation.⁹²

C. Buy-in Requirement

To preserve the relationship between costs and anticipated income, adjustments are mandated whenever one party contributes intellectual property already developed. The dash seven regulations require that the party contributing the pre-existing intangible must receive a buy-in payment, which will represent arm's-length compensation for use of the contributed property by the other parties.⁹³ Determining the arm's-length payment will re-introduce the transfer pricing methodology of the dash four regs, which otherwise would have been avoided by use of the cost sharing arrangement. The scope of the pricing issue is more limited, however, since only the value of the contributed property, and not the value of the intangible to be developed, must be determined using the dash four methods.

Although narrower, the valuation of the contributed property may be especially difficult, since the intangible may be inchoate, ill-tested, and without any objective comparables at all. This uncertainty may represent more discretion for the taxpayer in valuation, and an opportunity to retain most of the development costs domestically. For example, DC might substantially develop

technology within the borders of the United States, taking full advantage of section 174 deductions as well as section 41 credits, and then rely on a cost sharing arrangement for the finishing touches of the technology. Theoretically, this provokes a substantial buy-in payment, but, given the difficulty of valuation, DC may be able, intentionally or unwittingly, to understate the value. It is however clear that the Service perceives potential abuse of the dash seven regulations through undervaluation of contributed property. It has routinely criticized taxpayer valuation methodology in this context.⁹⁴

The buy-in requirement is likely to crop up somewhat often.

The buy-in requirement is likely to crop up somewhat often. In the ordinary case, an intangible would have to undergo some predevelopment before a cost sharing arrangement could be meaningfully negotiated. The buy-in requirement is itself fairly sweeping. If a participant conducts basic research not associated with any product, or provides the benefit of its ongoing value in its own research facilities, this also may represent a contributed intangible requiring a buy-in payment.⁹⁵ The buy-in requirement may apply even in the case where one party later acquires another subsidiary,

which brings technology useful to the new development.⁹⁶

The form of the buy-in payment is generally left to the taxpayers, and the dash seven regulations specifically provide for payment by lump sum, installments, or by royalty.⁹⁷ However, the Service has suggested that payments for contributed technology should take the form of a "stream of commensurate-with-income royalties extending over the useful life of the transferred intangibles," and that the Service may unilaterally extend the stream of payments previously contracted for by the parties.⁹⁸

⁹¹FSA 200003010 (18 Oct. 1999). See also pending cases *Seagate Technology v. Commissioner*, T.C. No. 15086-98, and *Xilinx Inc. v. Commissioner*, T.C. No. 4142-01.

⁹²Cost sharing payments are treated as reimbursement and are not taxable income. Such payments may reduce deductions, but in a pending case, the petitioner has argued that such payments will not reduce deductions under the rules of section 83(h) unique to stock options, which require that any employer is entitled to a deduction under section 162 "in the amount of income recognized by the employee" which is normally the full value of the option when exercised. See "Petitioners Memorandum of Law in Support of Motion for Partial Summary Judgment," Docket 4142-01 (4 Feb. 2002), *Xilinx Inc. v. Commissioner*, U.S. Tax Court.

⁹³Income Tax Regulations, section 1.482-7(g). Departing parties who take with them intangibles developed under (or contributed to) the cost sharing arrangement may be required to make "buy-out" payments in respect of such intangibles. It is arguable that withdrawal of one participant from a cost sharing arrangement may not necessarily confer benefits on the remaining participants.

⁹⁴See for example FSA 200023014. Cf. Levey and Garofalo, *op. cit.*

⁹⁵Treasury White Paper, *op. cit.*, note 5, at p. 219.

⁹⁶FSA 200001018.

⁹⁷Income Tax Regulations, section 1.482-7(g)(7).

⁹⁸FSA 200023014.

D. Administrative Requirements

The regulations impose several administrative requirements before a taxpayer⁹⁹ can take advantage of a qualified cost sharing arrangement. It is clear that the Service disfavors cost sharing arrangements and may wield these administrative requirements rather aggressively to disqualify otherwise valid cost sharing arrangements. The administrative requirements are clearly burdensome,¹⁰⁰ although less so than the transfer pricing regulations that would otherwise apply.

Contemporaneous Writing. Taxpayers seeking to enter into cost sharing arrangements are required to make a formal election and to document the specifics of the agreement contemporaneously.¹⁰¹ U.S. participants are required to include a copy of the agreement with its first return filed subsequent to the agreement's effective date.¹⁰² This latter requirement has been strictly construed in two recent cases.¹⁰³ Even where a taxpayer clearly mentioned a cost sharing arrangement and provided a transfer pricing study analyzing the cost sharing arrangement, the Service disqualified the otherwise-valid cost sharing arrangement because it was not attached to the return as literally required by the regulations.

Records. Taxpayers making the election agree to produce the records of itself and of foreign participants necessary to verify the computation and appropriateness of the respective cost shares; it must produce them in English and in the United States, within 30 days of a request by the Service.¹⁰⁴ At a minimum, the parties must be able to demonstrate the total costs incurred under the cost sharing arrangement and the costs borne by each controlled participant,¹⁰⁵ describe the methods used to determine each participant's share of costs and benefits, and describe any intangible property made available and the buy-in payment therefore.

Accounting Standards. Taxpayers must use consistent accounting methods in determining costs and benefits, including foreign currency translations.¹⁰⁶ The cost sharing arrangement must describe the accounting methods used to determine costs and expected benefits.

Scope of Intangibles. The regulations do not appear to place any meaningful limits on the scope of intangibles to be covered by the cost sharing arrangement, as long as the benefits of the covered intangibles are susceptible of reliable measurement.¹⁰⁷ "Intan-

The administrative requirements are clearly burdensome, although less so than the transfer pricing regulations that would otherwise apply.

gible" is broadly defined to include any item whose value derives from intellectual content as opposed to physical attributes.¹⁰⁸ Although the Treasury initially conceived that cost sharing arrangements would apply only to intangibles used in manufacturing,¹⁰⁹ that restriction never found its way into the final regulations.

The current regulations probably function effectively to apportion costs accurately between the parties, but may not effectively substitute for the transfer pricing regulations in ensuring that the taxable income of the related

parties accurately reflects their economic contribution to the activity.

IV. Options to Deter Migration

It is clear that cost sharing arrangements often function as tax-advantageous devices for the development of intangible property. As a result, ownership of significant rights in valuable intangibles will increasingly come to rest offshore,¹¹⁰ and it is apparent that this migration works to the general detriment of the U.S. economy.¹¹¹

⁹⁹The Service may elect to treat an agreement as a cost sharing arrangement notwithstanding that it does not meet the formal requirements. Income Tax Regulations, section 1.482-7(a)(1). The Service may be so motivated in a case where FC receives royalty payments from DC, especially when withholding taxes on the royalties are reduced by treaty.

¹⁰⁰Comments in response to the 1995 regulations; Treasury White Paper 1988.

¹⁰¹Income Tax Regulations, section 1.482-7(b).

¹⁰²Income Tax Regulations, section 1.482-7(j).

¹⁰³FSA 200009022 (30 Nov. 1999). See also FSA 200011021 (15 Dec. 1999).

¹⁰⁴Income Tax Regulations, section 1.482(j)(2).

¹⁰⁵Income Tax Regulations, section 1.482-7(c)(1)(iii).

¹⁰⁶Income Tax Regulations, section 1.482-7(c)(1).

¹⁰⁷Income Tax Regulations, section 1.482-7(c)(1)(i). Intangible properties developed pursuant to a cost sharing arrangement are referred to as "covered intangibles," which also include property not foreseen at the time of the arrangement but subsequently developed from the research activity.

¹⁰⁸Income Tax Regulations, section 1.482-4(b). See also section 1.482-7(b)(4)(iv).

¹⁰⁹Treasury White Paper, *op. cit.* note 5.

¹¹⁰Although empirical data are not readily available, both the apparent result of the regulations and anecdotal evidence suggest that significant intangible assets are beginning to flow offshore.

The migration problem follows, in a real sense, from tax competition between sovereign nations. Countries that tax income at lower rates attract investment, in competition with nations having higher tax rates. Certainly, other factors — the availability of an expert workforce, the local cost of raw materials, currency exchange rates, political stability, and a host of other economic factors — may influence investment decisions more than tax regimes. Nevertheless, tax competition can be fierce, and in this sense, offshore migration is only a modest response to a relatively larger stimulus.¹¹²

Differences in tax rates more readily affect those sources of profit that move across borders, hence intellectual property profits are more susceptible to tax competition. To the extent that an answer lies in competing more aggressively, U.S. tax preferences should focus on intangible properties. Preferential U.S. tax treatment of gains and profits from intellectual property would counteract the incentive to invest in foreign intellectual property through cost sharing arrangements. However, such a preferential tax is unlikely to pass Congress, or to find popular support. In any case determining the magnitude of the required tax preference would be difficult; the dollar impact of the cost sharing arrangement loophole is difficult to estimate with any accuracy.

Instead, as a more direct solution, consider a more rigorous application of general transfer pricing principles to cost sharing arrangements. Current abuse of transfer pricing principles occurs through the use of cost sharing arrangements where there is a disparity between the cost ratio and the profit ratio of the foreign and domestic entities. That is, abuse occurs where the domestic entity (in comparison with its foreign counterpart) has had the advantage of relatively greater deductions but also enjoys the

advantage of relatively lesser income. Where foreign income is higher than predicted by the cost sharing arrangement, domestic (deductible) costs have been proportionally higher and domestic (taxable) income proportionately lower, effectively reducing revenues to the U.S. Treasury.

The current regulations allow the Service to revisit *cost* allocations when actual benefits depart from expected benefits by more than 20 percent, but (unlike the general transfer pricing regulations) they do not provide the Service a tool to reallocate the *income* from the intangible. To

The migration problem follows, in a real sense, from tax competition between sovereign nations.

fully implement the intent of the transfer pricing regulations, the Service must reclaim the right to determine that *deemed* income has accrued whenever foreign entity income from intellectual property under a cost sharing arrangement has exceeded that predicted by the parties under the agreement. Section 482 is sufficiently broad to allow the Service to find deemed income in this way, but it has abandoned that right, as an exception to general transfer principles, in the case of cost sharing arrangements.

When intangibles have produced income for the domestic

and foreign entities that is out of proportion to their division of costs under the cost sharing arrangement, the Service should adjust not only the costs, but also the income. Specifically, *costs* should be adjusted when income falls more heavily to the foreign entity than predicted, and *income* should be adjusted when the income falls more heavily to the domestic entity than predicted. In that case, income should be adjusted so as to comport with the ratio of domestic to foreign entity income that was predicted by the parties in the cost sharing arrangement.

To avoid penalizing the taxpayer — and to preserve the incentive to accurately forecast profit divisions — the Service's authority to revise profit allocations must be limited. Profit allocations should be adjusted only to the extent that cost allocations, as set in the cost sharing arrangement, were inaccurate. Expressed mathematically, where:

I = Actual income from operations for taxable year for all related entities who are party to the cost sharing arrangement;

X = The ratio of U.S. income to total income (U.S. taxable income/I) during taxable year; and

Y = the ratio of U.S. costs to total costs, as predicted by the cost sharing arrangement (costs allocated to U.S. entity/total costs allocated to all related entities), which must, by regulations, be a reasonable prediction of the future income ratio x;

Then income adjustments should be limited to $I(X-Y)$.

For example, suppose that in year 1, DC and FC agree to share costs of development of intellectual property P in the ratio 50:50 under

¹¹¹See note 2 *supra*.

¹¹²See Johnston, David Cay, "U.S. Corporations Are Using Bermuda to Slash Tax Bills," *infra* note 3.

a qualified cost sharing arrangement. Assume costs of development are \$10x and DC has deducted \$5x. Now assume that in year 5, profits from P are \$20x to DC and \$80x to FC. The ratio of U.S.-to-foreign costs, 50 percent, exceeds the ratio of U.S.-to-foreign income, 20 percent. Under the proposed rule, Treasury should be able to apply section 482 to shift income from FC to DC in the sum \$30x, that is, the total profit (\$100x) multiplied by the difference of the ratios (50 percent minus 20 percent).

Certainly, this approach entails some increase in the administrative burden on the taxpayer as well as the Service, but the principle central to transfer pricing is preserved: that the income allocated among related parties reasonably reflects the actual economic activity undertaken by each.

This method moreover allows valuation of intellectual property in hindsight; mirroring the intent of section 367(d), the valuation of intangibles can be determined from actual profit experience, rather than relying on early estimates of the inchoate property. Indeed, Congress intended section 482 to permit cost sharing agree-

ments only to the extent that results would be consistent with this "commensurate-with-income" standard.¹¹³ Subjecting transfers made under cost sharing arrangements to the same scrutiny as other controlled-party transfers would end the role of cost sharing arrangements as a loophole in the transfer pricing regime.

V. Conclusion

Cost sharing arrangements have emerged as a weakness in the transfer pricing regime, which has led, inadvertently, to the migration of intellectual property to foreign owners. Despite the Service's suspicion of cost sharing arrangements (and its vehement enforcement of the related administrative requirements), these arrangements continue to motivate developers to invest offshore; especially so where the investors perceive that long-term prospects for the property are relatively good, without overarching risk, and where the worldwide market for the property will be significant.

In the big picture, this migration must be seen as an artifact of the more general phenomenon of tax competition.

Pressure for profitable property to travel offshore will remain with us as long as U.S. tax rates are impressive and the U.S. maintains its policy of taxation of citizens on worldwide income. Since intangible property moves so readily, a reduced tax rate on profits from intellectual property would counter this effect, but implementation of such a tax preference would be difficult. In the short term, a more pragmatic solution is to subject cost sharing arrangements to transfer pricing principles in those situations of abuse, where offshore profits have been unexpectedly high. The Service is authorized to make such an adjustment under section 482. Now that cost sharing arrangements are understood as promoting the migration of intellectual property offshore, the Treasury should adopt regulations to exercise this right. ♦

¹¹³H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986). See the Treasury White Paper, *op. cit.* note 5.



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