Daily Tax Report

Maruca Defends Income Method, Argues For 'Common Sense' In Valuing Intangibles

February 14, 2013

By Dolores Gregory

One of the Internal Revenue Service's challenges in defending the income approach to valuation of intangibles is that while the assets at issue often are inherently unique, courts nevertheless are more inclined to favor the comparable uncontrolled transaction (CUT) method, an IRS official said Feb. 13.

"Lawyers like CUTs. They want something to hang on to. They are not comfortable with income methods, which incidentally, businessmen use thousands of times a day to evaluate potential transactions," Samuel Maruca, director of transfer pricing for IRS, said during a Tax Council Policy Institute conference in Washington.

Too often in valuing intangibles, taxpayers "get buried in minutiae and common sense goes out the window."

Samuel Maruca, IRS director of transfer pricing

Among the topics discussed was the question of whether a gap exists between economics and the law in the valuation of outbound transfers of intellectual property. The panel, which included economist Anthony Barbera of Charles River Associates and attorney Duane Webber of Baker & McKenzie, focused on Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009), as a case study (236 DTR K-1, 12/11/09).

Barbera observed that the taxpayer's approach for determining a buy-in payment in Veritas--relying on a declining royalty rate over the useful life of the intellectual property--did not reflect an approach that most economists would support. "When you transfer IP you are transferring income--cash flow," he said. "You have a stream of income. The question is how long is it going to last?"

'Common Sense.'

A company will not sell a research and development activity for less than what it could earn if it continued the activity, he said. "It seems it is not really sophisticated economics, it is just basic common sense," Barbera said. "If I expect to generate this much income over a period of time [from an activity] and someone wants to buy it, they are going to have to generate at least as much as I could earn by continuing to do it."

Common sense, Maruca agreed, often seems to be absent from the kinds of transaction valuations that catch IRS's eye. Maruca noted that IRS is most concerned with transactions that involve the transfer of a "core enterprise technology" that gives the taxpayer a competitive advantage and enables it to earn returns "in excess of standard cost accounting."

In the cases IRS is focused on, Maruca said, when a core enterprise technology is transferred to a foreign related entity, if the foreign party is bringing any intangibles to the table, they are "probably pretty routine." Yet the values assigned to the foreign entity's contribution are far in excess of what common sense would suggest is reasonable, he said.

Webber said that economics and the law are split on many transfer pricing questions because economics proceeds from a set of principles that is not necessarily consistent with the principles rooted in the law. Business operators might rely on the advice of economists, but they also take other factors into account, he added.

Income Method

Webber said the cost sharing regulations at the time of Veritas did not mandate an income approach. "The law did not say that you should treat the transfer of previously developed intangibles as the sale of a business," he said. "And to the extent that the new regulations mandate that and to the extent that it is not consistent with all business practices, we might see a challenge to that regulation."

Taxpayers cannot be held to a standard set by a "particular economist in a particular case," Webber said. "We have to have rules to follow."

Maruca agreed that the law itself is "not particularly clear." However, in transfer pricing, he said, the two basic questions are what is the transaction and what is the most reliable way to price it. Too often in valuing intangibles, taxpayers "get buried in minutiae and common sense goes out the window." As a result, "you consistently get outcomes that are too good to be true," he said.

"I don't think there is any escaping that there is no one right answer," Maruca said. "You have to do the best you can to understand the facts in front of you, what is the transaction, what are the value drivers. In the end there is going to be disagreement; we just have to try to narrow the range of disagreement."

But he disputed the argument that by using the income approach, IRS is attempting to recharacterize or restructure a taxpayer's business.

"We kind of think this battle was fought and decided in 1986 and when the regs were issued, which permit us to apply a CPM type analysis to a foreign entity that is not bringing significant intangibles to the table," he said.

Federal Tax Day

IRS Official and Practitioners Discuss Transfer Pricing Questions at TCPI Symposium

February 14, 2013 Thursday

By Brant Goldwyn

Samuel Maruca, IRS director of transfer pricing operations, and three transfer pricing professionals met on February 13 to discuss several transfer pricing questions. Maruca also described the current structure of the IRS's transfer pricing program.

Private participants included Paul Oosterhuis, partner, Skadden, Arps, Slate, Meagher & Flom LLP, Washington, D.C., who moderated the discussion; Anthony Barbera, economist and senior consultant, Charles River Associates, Washington, D.C.; and Duane Webber, partner, Baker & McKenzie LLP, Washington, D.C. The panel was part of the 14th Annual Tax Council Policy Institute Symposium, focusing on the taxation of intangibles.

The IRS's international division is transitioning to a focus on issues, Maruca noted, with transfer pricing in the lead. The Service has set up an international business compliance (IBC) unit and is moving staff from its industry groups to its issue groups.

Maruca described the IRS's structure for its transfer pricing operations (TPO). The TPO has three components: the Transfer Pricing Practice (TPP); the Advance Pricing and Mutual Agreement Program (APMA); and the International Practice Networks (IPN). The TPP began in September 2012. The organization is young and small, but the IRS plans to grow it.

The TPP consists of three territory managers -- east, central and west, Maruca said. Each territory manager will supervise two managers who will manage teams of eight to 10 people. The TPP is scrutinizing its inventory and will determine what work it should focus on. "We want to be engaged in the important cases from day one," Maruca said. The TPP also wants cases to be well-developed.

The TPO is dependent on the IBC process, which includes front-line examiners. "We're there to help [examiners]," stated Maruca. Oosterhuis noted that most international economists are not even in the TPP. Barbera asked whether a taxpayer under audit should contact TPP, if the IRS audit group has not brought it. Maruca said that, ideally, the process world work through the IBC, but he indicated that a taxpayer could suggest that the transfer pricing group be involved.

IPNs are networks of IRS "practitioners" who will study both inbound and outbound transactions, Maruca indicated. The TPO is building a library that is focused on transactions and that will be used to understand specific transactions. Maruca wants to see IPNs used as a tool or aid to analysis, not as a template for pigeon-holing a transaction.

The TPO has developed and will be issuing a best practices manual, which Maruca referred to as the road map. The road map will be used for planning and risk assessment, and development of the audit process. The TPO wants to engage taxpayers early in the audit process and wants taxpayer submissions as early as possible to study and understand. "We want to see studies even before our first meeting with taxpayers," Maruca said.

Webber asked whether the audit team can still work an issue if the TPP team decides it does not want to work the issue. Maruca said that hopefully there is consensus; the decision-making focus is on expertise, not position.

Oosterhuis asked whether there are gaps between economics and the law in the pricing of outbound transfers of intellectual property (IP). According to Barbera, transferring IP is transferring a stream of income. It is basic common sense, not sophisticated economics, to value the transfer based on the discounted value of the income stream. Webber said that economics and the law depart on many transfer pricing issues. Taxpayers cannot be held to the standards of economics; we need a regime with rules that we can follow.

Maruca agreed that transfer pricing needed principles and predictability, but he said that the law is not particularly clear. A key issue is identifying the transaction and putting a price on it. He noted that common sense is needed, but that maybe the system needs fewer rules for effective administration. "Common sense means can the law be reconciled with a reasonable outcome? Can we interpret the law to attain the proposed result? It is necessary to focus on where the value is coming from," Maruca said.

Oosterhuis asked about the right approach in the absence of comparable transactions: a broad approach, casting a wide net; or a targeted approach, using the best available comparable transactions and adjusting as necessary. "Would another approach be preferable, such as the profit split method?" he asked.

The profit-split method is workable, according to Barbera. There are principles and a formulaic way to split profits between two parties, but ultimately it is a negotiation. Webber said the profit-split method is good for some issues, but it lacks a measurement metric. He would prefer to start with the closest comparable transaction and work from that, using both the facts and the law to help resolve issues. Again, Webber emphasized the need for rules.

Maruca said there is going to be disagreement; the goal is to narrow it. That is what the government is struggling with. Typically, there are not comparable uncontrolled transactions. The best method depends on the facts, but the IRS is not trying to restructure a taxpayer's business when it values a transaction.

Tax Notes Today

R&D Regime Must Improve Certainty On Eligible Costs, Practitioner Says

February 14, 2013

By Kristen Parillo

Improving taxpayer certainty on eligible research and development expenses should be the government's priority to ensure that the United States has a competitive R&D regime, according to Michael Goldbas of Deloitte Tax LLP.

When firms conduct a comparative analysis of different countries' R&D regimes to see which offer more generous benefits, eligible costs -- rather than tax rates -- are more critical because the design elements of regimes can vary significantly, Goldbas said at a February 13 session of the Tax Council Policy Institute's annual Tax Policy & Practice Symposium in Washington.

"One thing that I believe distinguishes the U.S. from most countries is simply certainty as to what costs qualify and what don't," he said. "I think that's where, in some ways, we are behind the curve. In a lot of countries, there is approval required before you can get a credit or a refundable credit, or you can get preapproval for projects. There's simply less dispute over what kinds of costs qualify."

The current practice of approving one-year extensions of the existing R&D credit regime, and the incremental nature of the credit, also limit taxpayer certainty and hinder the goal of encouraging innovation and risk taking, Goldbas said.

Tracee Fultz of Ernst & Young LLP said policymakers should evaluate the effectiveness of the current R&D incentives, many of which were introduced several years ago, to determine whether they align with today's global economy. She said policymakers must first decide what activity they're trying to encourage before developing a mission statement.

Fultz noted there has been much debate about whether the United States should follow the global trend and introduce a patent box. However, she noted that R&D credits and patent box regimes have different goals. A patent box is designed to stimulate innovation and encourage intellectual property development, while an R&D credit acts as an incentive to do the research now, she said.

"They do encourage different activity, and it's important to know what that is before deciding on a policy to adopt," Fultz said. She further noted that most countries that have expanded their R&D regimes in recent years did so in the context of broader tax reform.

Mike Williams, director of business and international tax at HM Treasury, said that the U.K. government developed its recent reform of R&D incentives as part of a broader strategy to increase the United Kingdom's attractiveness as a location for innovation. Along with reducing the corporate tax rate from 28 percent in 2010 to 21 percent in 2014, the United Kingdom is set to introduce a patent box and a refundable above-the-line R&D credit in April. (Prior coverage (Doc 2012-6041). Prior analysis (Doc 2011-19489).)

The U.K. government consulted closely with the business community when developing the policy design and implementation of the new incentives, Williams said. "That's a key point," he said. "If you want to incentivize people through R&D credits or a patent box, then the people you want to incentivize need to feel incentivized."

Consulting with business also helped policymakers decide on what features would work best in practice and obtain the maximum incentive effect, Williams said. Though there were setbacks at some points of the U.K. consultation with business, a high level of trust between the government and taxpayers built up over time, he said.

Williams said that, as a tax policy official, it's more persuasive when a business argues a point from its own experience and explains why certain ideas aren't possible, rather than use a model that may reflect results pertaining to only a limited number of taxpayers. "It's been very valuable to be able to do that. Of course, there were some things people were prepared to talk about in a room with lots of other business people there, and there were also some things people were obviously only prepared to talk about on a one-on-one basis. So we had to balance that."

Panel moderator Madeleine Barber of Tyco International said that some observers have wondered whether there must be a trade-off between introducing a new incentive like a patent box and reducing the corporate tax rate. "Obviously, the U.K. has reduced its rate and is introducing a patent box and above-the-line credit, so I don't think there necessarily needs to be a trade-off, but certainly from a U.S. perspective, trying to score what a patent box would cost in terms of revenue is probably going to be somewhat difficult."

Williams said that having a strategy beforehand can help defend against claims that the government is "giving away" tax revenue to business. "Given the difficulties countries are facing with deficits, in many cases taxes are being raised," he said. "You've got to have a defense as to why it's right that this group should pay less tax while an ordinary person on the street is maybe paying more."

Developing a good strategy as to why a tax incentive is necessary to help increase jobs and economic growth can help the government defend its policy choices and increase public acceptance of those choices, Williams said.

Tax Notes Today

OECD Moving Quickly With Base Erosion Project

February 14, 2013

By Julie Martin

The OECD is further along with its base erosion profit-shifting (BEPS) initiative than the just-released BEPS report (Doc 2013-3276) suggests, Joseph Andrus, head of the OECD's transfer pricing unit, said February 13 at the Tax Council Policy Institute's annual Tax Policy & Practice Symposium in Washington.

The OECD's Business and Industry Advisory Committee has participated in one or two meetings on base erosion, Andrus said, adding that the OECD is reaching out to nongovernmental organizations and non-OECD member countries. China and India are both "enthusiastic endorsers" of the work and are participating in it, he said. Andrus emphasized that it is politically imperative to move quickly on the project.

Andrus said it is significant that the BEPS report was approved unanimously by all 34 OECD members, adding that the integrity of the corporate tax base is at stake.

Garry Stone of PricewaterhouseCoopers LLP said the report uses troubling language, such as suggesting that arm's-length pricing methods are broken and that intangibles aren't "real" or "substantial." The report also uses the word "scheme" frequently, Stone pointed out.

Andrus responded that government officials working on the report believe something is broken in the transfer pricing system. "Whatever it is we are doing isn't producing accurate results if it turns out that 75 percent of the world's income, under a transfer pricing system, is reflected as being earned in Singapore, Switzerland, the Cayman Islands, and Bermuda," he said.

Andrus said the treatment of transfer pricing may hinge on jurisdiction to tax issues. If the permanent establishment standard is deemed the problem, and it is determined that a provider of electronic digital goods without a fixed place of business in a country should be taxed in the customer's country, a transfer pricing system that uses functions, assets, and risks makes little sense, he said.

Regarding the OECD intangibles project, (Doc 2012-12174) Andrus said it is unlikely that the next draft will significantly change the definition of intangibles. The delegates have not been swayed by industry arguments that the definition should be clearer, Andrus said, because they don't want companies to argue that because something doesn't technically fit within the definition, it need not be paid for.

Andrus identified five critical issues to be worked out before the OECD can release the next version of the draft. They are (1) the treatment of goodwill and workforce in place; (2) the treatment of items the OECD has suggested should be treated as comparability factors, such as location savings, local market advantages, and synergies; (3) how legal ownership of intangibles relates to performance of functions and bearing of risk; (4) valuation method issues; and (5) what to do with intangibles that are difficult to value.

Andrus said the goal is to publish the next discussion draft in the second half of 2013.

Federal Tax Day

Hatch Calls for Fresh Start to Tax Reform

February 15, 2013

By George Yaksick

"We need to define what tax reform is and what it is not," Sen. Orrin G. Hatch, R-Utah, ranking member on the Senate Finance Committee, told the 14th Annual tax Policy and Procedure Symposium of the Tax Council Policy Institute (TCPI). Hatch added that policy-makers also must pay attention to intangible investments and how the tax code affects intangibles. The theme of the 2013 TCPI symposium was the capitalization of intangibles.

Fresh Start

"It is time for a fresh start," Hatch said. "It's been years since the last overhaul of the tax code. We need to reform the tax system in its entirety." Hatch emphasized that tax reform must be comprehensive, which he described as encompassing both individual and business tax reform. "We cannot reform one without the other."

President Obama called for tax reform during his February 12 State of the Union Address (TAXDAY, 2013/02/13, W.1), Hatch noted. But he predicted that the president's proposals "would make real tax reform more difficult in the future." According to Hatch, Obama's plans "would simply eliminate certain tax loopholes for deficit reduction or to pay for additional spending."

General Principles

Hatch described several broad principles for tax reform, which he acknowledge were from "30,000 feet" and much more detail would be needed. According to Hatch, tax reform should:

Promote economic growth and eliminate impediments to job creation;

Reduce the top corporate tax rate;

Move the U.S. to a territorial system of taxation;

Be revenue neutral; and

Broaden the tax base to lower rates.

"Some of the largest tax expenditures are the most popular." These include the home mortgage interest deduction and the deduction for qualified contributions to charities, he noted. "We will not accomplish tax reform without compromise."

On February 13, the House Ways and Means Committee announced the formation of 11 tax reform working groups (TAXDAY, 2013/02/14, C.1). Hatch did not mention the Ways and Means working groups in his remarks. In the past, the GOP chairman of the Ways and Means Committee has expressed support for moving the U.S. to a territorial tax regime and lowering the corporate tax rate.

Intangibles

Hatch called intangibles increasingly important in the global economy and drivers of growth and competitiveness. He characterized the tax treatment of intangibles as a "challenge" and added that "one of the main problems with the taxation of intangibles is that they are highly mobile."

Spending

Along with tax reform, Hatch said, "It is equally vital that we get federal spending under control." He noted that the federal government has had "four consecutive years of trillion-dollar deficits."

Tax Notes Today

Officials And Stakeholders Debate Reform Of Intangibles Income Taxation

February 15, 2013

By Jaime Arora

Government and business representatives agree that the taxation of intangible income plays an important role in international tax reform and base erosion but on February 14 debated White House and House Ways and Means Committee proposals, focusing on how they might affect corporate behavior and whether they would promote economic growth during the Tax Council Policy Institute's Symposium on the Taxation of Intangibles in Washington.

Administration's Proposals

Michael F. Mundaca of Ernst & Young said that the administration has offered two proposals on the taxation of foreign-source intangible income. The first, Mundaca said, is the excess returns proposal, presented in President Obama's past budget proposals. It would treat excess returns associated with transfers of intangibles by a U.S. person to a related controlled foreign corporation as subpart F income if the income is subject to a low foreign effective tax rate, he said. Low is defined as 10 percent or less, with a ratable phaseout for effective tax rates of 10 to 15 percent. The second proposal, in the President's Framework for Business Tax Reform, would subject earnings of foreign subsidiaries of U.S. corporations to a minimum rate of tax, Mundaca said. (Framework (Doc 2012-3711).)

Speaking on his own behalf, Mundaca, a former Treasury assistant secretary for tax policy, said the two approaches illustrate different concerns on the part of the administration. The excess returns proposal is intended to address the inappropriate shifting of income outside the United States, while the minimum tax proposal focuses on tax structures in other countries and seeks to stop the race to the bottom of corporate tax rates, he said. The United States is looking to influence the rates that other countries set, Mundaca added.

Options in Camp's Comprehensive Income Tax Reform Draft

In 2011, Ways and Means Chair Dave Camp, R-Mich., released a discussion draft that proposes lowering the corporate tax rate to 25 percent and moving the United States to a territorial tax system. Camp's proposal features three options for combating base erosion. Option A resembles the administration's excess returns proposal. Option B treats all CFC earnings as subpart F income unless they are derived from the CFC's home country or are subject to a foreign effective tax rate of more than 10 percent. Option C would lower the corporate tax rate for all foreign intangible income to 15 percent but treat a CFC's foreign intangible income as subpart F income if it is taxed at a rate less than 13.5 percent, which is 90 percent of the U.S. rate. (Prior coverage (Doc 2012-19529).)

"Option A is really more of a marker," said E. Ray Beeman, Ways and Means majority tax counsel. That option was included to make clear that everything is on the table and that this is only one approach, Beeman said. Camp won't reject it just because it was Obama's proposal, he added.

Beeman said that option B is structured similarly to approaches in other countries. Camp recognized at the outset that one of the tests in option B may not suit current U.S. business models but included it to encourage stakeholders to provide feedback and alternatives, Beeman said. "We haven't gotten a lot of feedback on what might be swapped into that test," he said, adding that it has been difficult to find a rule appropriate for companies of different sizes and structures.

Option C deals only with income from intangibles and option B applies to all earnings, but option C encompasses more than option A, Beeman said. It applies to all intangibles, while option A applies to only migrated intangibles, he said. Further, option C includes both a carrot and a stick and incorporates patent box considerations, which other options would address separately, he said.

The main theme of option C is to recognize that it can be difficult to differentiate between truly U.S. intangibles and truly foreign intangibles, Beeman said, adding that "the vast majority of fact patterns live in a very large gray area." Option C does not attempt to make such difficult distinctions and instead treats all intangibles the same, he said.

However, option C is not without problems, Beeman said, adding that many discussions have focused on the challenge of administrability. As drafted, option C does not offer rules for identifying intangibles or intangibles income, he said. The task of separating something that is embedded and giving it a different tax treatment "is just asking for problems," Beeman said. Consideration has been given to sacrificing some precision in order to make the option more administrable, he said.

Most discussion with business representatives has focused on option C, and not much attention has been paid to option A or B, Beeman said, adding that option A is widely perceived to reflect the administration's view.

Providing the corporate perspective, Mike Reilly of Johnson & Johnson said option A has an element of fairness because it applies only to intellectual property that has been transferred. However, it can be difficult to determine when that transfer has been made, he said.

Ronald Dickel of Intel Corp. said that the problem with option A is that it could have negative behavioral effects. It provides that if a company develops intellectual property in the United States but uses it overseas, it will be subject to a tax, which would encourage companies to move more and more of their research and development offshore, Dickel said.

Reilly said that option B might be easier to apply but if the effective tax rate of the CFC's jurisdiction were 10.1 percent, it would have no effect, and if it were only 9.9 percent, it would be immediately subject to tax. Not only would it be immediately taxed, but a CFC in that jurisdiction would be taxed at a rate of 25 percent, Beeman said.

Option B does not encourage job growth and economic activity in the United States, Dickel said. Assuming that a company hits a threshold number, it can keep its earnings offshore and not be subject to tax, he said. He cautioned, however, that leaders must consider the greater economic impact of the proposed changes.

Dickel said that option C represents a "great opportunity to reform the international tax system and yet encourage economic activity in the U.S." The carrot and stick of option C provide for parity, he said. The stick is that income from goods and services produced abroad but consumed in the United States would be subject to the full U.S. tax of 25 percent, the same treatment as if the goods or services were produced and sold domestically, Dickel said. The carrot promotes parity because if a company produces something in the U.S. that is consumed abroad, it will be subject to a 15 percent tax rate, the same rate that would apply had the production also occurred abroad, he said.

While options A and B do not include a carrot, option C would level the playing field and encourage companies to keep their research and development in the U.S., which would promote domestic economic activity, Dickel said.

Tim McDonald of Procter & Gamble Co. said that although option C needs more work, it is a good start.

Reilly said that a group of companies came together to develop a fourth option, option D. Focusing on the dividends received deduction, Reilly said, option D supplies three different rates, depending on the tax rate imposed on the CFC where the income is earned. If the CFC's earnings were subject to an effective rate of 15 percent or higher, the receiving corporation would get the full 95 percent deduction, he said. For a rate of 7.5 to 15 percent, the deduction would be set at 85 percent, and for a rate of less than 7.5

percent, it would be 75 percent. Reilly said that option D is still being refined and that its developers welcome suggestions.

Reilly said that he worries about any proposal that would differentiate particular types of intellectual property income. That would make the system more complicated and give companies an incentive to identify a larger part of their income as being of the type not subject to a specific rule on targeted intellectual property, he said.

Making Predictions Amid Uncertainty

Turning to what companies can do to prepare in the midst of such uncertainty, Dickel said that on the international side of taxation, the Camp proposal is an excellent place to start.

Hank Gutman of KPMG LLP said that even if companies focus on Camp's draft, they shouldn't ignore the administration's proposal, because it includes many different international elements. There is likely to be an amalgamation of the two views at some point, he said. "If the train starts moving, everything is in play," McDonald said.

Mundaca said that amalgamation might happen on the Senate side. Though there is a good sense of the House's and administration's positions, not much is known about what will happen in the Senate, he said.

Consensus That Reform Is Necessary

Gutman asked the group if the business community might come together to support one of the current proposals. Revenue-neutral proposals are a zero-sum game, he said, adding that it could prove difficult to reach agreement when business is discussing whose share of taxes paid will change given that the overall amount will remain fixed.

Dickel said that CEOs realize there will be winners and losers in the corporate debate and that some CEOs are willing to be losers if it will help the U.S. economy to grow. Business is "looking to grow the pie rather than divide a shrinking pie," he said.

"We want reform," McDonald said. "We think it's the right answer." He added that it's worthwhile for companies to engage Congress and the administration on tax reform, despite the risks. To remain absent from the discussions while asserting that reform doesn't look imminent would be a huge mistake, McDonald said.

Dickel said that it is pretty clear from all perspectives that the worldwide tax system is broken. The current environment is neither competitive nor pro-growth, he said. "Something has to be done," he said.

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HEADLINE: #7 2013 TNT 33-7 MARUCA OUTLINES IRS APPROACH TO TRANSFER PRICING. (Section 482 -- Transfer Pricing) (Release Date: FEBRUARY 15, 2013) (Doc 2013-3847)

CODE: Section 482 -- Transfer Pricing

ABSTRACT: The IRS approaches transfer pricing cases by first trying to understand the economics of a transaction and then looking to see if the law can be reconciled with a reasonable outcome, according to Samuel Maruca, transfer pricing director, IRS Large Business and International Division.

SUMMARY: Published by Tax Analysts(R)

The IRS approaches transfer pricing cases by first trying to understand the economics of a transaction and then looking to see if the law can be reconciled with a reasonable outcome, according to Samuel Maruca, transfer pricing director, IRS Large Business and International Division.

Taxpayers constantly argue for results that are too good to be true and that aren't supported in the real world by business at arm's length, Maruca said February 13 during the Tax Council Policy Institute's Symposium on the Taxation of Intangibles in Washington. All too often, the IRS and taxpayers get bogged down with the minutiae of a case, focusing on questions such as whether an item is an intangible "on the list," how to account for it, whether it is transferable, whether it is "property," and so on, Maruca said, adding that the result is often that "common sense goes out the window."

The government is seeking to truly understand the economics of a deal, as opposed to all the individual elements, Maruca said. Once the economics are understood, the IRS asks if there is a way to interpret the law that is consistent with that outcome, but sometimes it is not possible to interpret the law so that a reasonable outcome can be achieved, he said.

AUTHOR: Martin, Julie
Tax Analysts

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The government is seeking to truly understand the economics of a deal, as opposed to all the individual elements, Maruca said. Once the economics are understood, the IRS asks if there is a way to interpret the law that is consistent with that outcome, but sometimes it is not possible to interpret the law so that a reasonable outcome can be achieved, he said.

A. Duane Webber of Baker & McKenzie said that there might be a "prudent challenge" to the new cost-sharing regulations to the extent that the regulations mandate a valuation approach that treats the transfer of a developed intangible as the sale of a business.

Taxpayers should not be held to a standard that the "economist du jour" believes will clearly reflect income, but need a regime that will allow them to get to that result, Webber argued.

Maruca said he did not believe the law was as clear as Webber characterized it. He added that the system might be better off with fewer rules, so common sense could prevail.

Maruca said that while many people think that the government lost in Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983) (95 TNT 128-123), because the government lost the sham argument, the case resulted in a significant allocation, which was based on a "story telling" of where the value was.

He said that although much of his work involves judgment calls, the IRS is most concerned about transactions that involve making available "core enterprise technology," namely the competitive advantage that allows a company to earn returns. Typically there are no comparables for those types of assets, he said. "Our challenge is that courts and lawyers like" comparable uncontrolled transaction methods and are not comfortable with income methods, he said.

Next steps for the UN and OECD for intangible assets and profit shifting

February 18, 2013

Sophie Ashley

The UN and the OECD are both working on important transfer pricing policy discussion reports and representatives from both organisations have said tax practitioners can expect significant developments in 2013.

Speaking at the TCPI Intangibles symposium in Washington last week, Michael Lennard, tax secretary for the UN, said the final version of the practical manual on transfer pricing should be published in May and Joe Andrus, head of the OECD's transfer pricing unit, told tax practitioners to expect the transfer pricing aspects of intangibles report in the latter part of the year "but certainly not in the first half".

Also up for discussion was the first report of the OECD's Base Erosion and Profit Shifting (BEPS) project, which was also released last week. The report has been approved by every member of the OECD (34 in total) and Andrus said this supports the idea that the integrity of the corporate tax system is at stake.

"The reflection that something is broken in the transfer pricing system is spot on," said Andrus. "75% of the world's income is earned in countries such as Singapore, Luxembourg and the Cayman Islands."

In addition to the UN's transfer pricing manual, Lennard said a new committee of experts on international cooperation in tax matters would be elected this year. The committee sits for a four-year term and consists of 25 people.

Michael McDonald, a financial economist in the office of tax analysis at the US Treasury, and a panellist in the same session at the TCPI symposium, said the primary issue in the BEPS report is about what the arm's-length principle (ALP) is. He said there is a question about the nature of unrelated parties. "There's no such thing as a free lunch, if it [price] sounds like too good a deal then you need to question it," he said.

The digital economy is also at the centre of the BEPS discussion because governments and international organisations have not worked out how to tax it yet.

Andrus also took care to reiterate that the OECD is happy to work with the UN on transfer pricing.

"I hope everyone is clear that the OECD is in cooperation with the UN. We are not displeased that the UN is working on transfer pricing issues. There is a lot of room for both organisations to make contributions on the issues that we have to deal with at both organisations," he said, adding that it is important to allow for a range of countries, not just big emerging markets and that tax policy needs to represent all countries in different stages of development.

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Intangibles

U.S. Tax Reform Should Consider Impact On Incentives for Innovation, Panelists Say

By ***Dolores W. Gregory***

Any effort to enact U.S. tax reform that focuses on the treatment of intangibles must be carefully crafted to balance the competing goals of protecting the tax base and encouraging innovation, various business and tax policy experts said Feb. 14 at the Tax Council Policy Institute's 14th Annual Tax Policy and Practice Symposium.

Many tax reform proposals are aimed at reducing the U.S. corporate tax rate—now at 35 percent—and paying for it through eliminating or reducing tax expenditures, but such an approach also could undermine the ability of the U.S. tax code to provide incentives for research and development.

“One of the most important questions is whether and how our tax code is going to continue to encourage innovation,” said Eric Solomon, former assistant secretary for tax policy at the U.S. Department of Treasury and currently with Ernst & Young LLP.

Solomon noted “conflicting trends” in discussions of business tax reform, with proposals that would eliminate certain tax expenditures and proposals that would increase expenditures in the name of encouraging job growth or innovation. At the same time, the U.S. is grappling with the question of how to stem the migration of intangibles offshore.

One way might be to create a more hospitable environment for innovation in the United States, several speakers suggested.

‘Schizophrenic' Policy

The federal research and development tax credit is a prime example of what one executive calls the United States's “schizophrenic” policy towards the development of intangibles. Originally introduced in 1981 as a temporary provision, the R&D credit has been repeatedly modified and extended, allowed to lapse, and extended again—retroactively through 2012—as part of the federal fiscal cliff negotiations.

David P. Lewis, vice president of taxes with Eli Lily and Co., in Indianapolis, noted that “capital goes where it is welcome and stays where it is nurtured. But the R&D credit and the way it has been turned on and off hasn't been consistent with that.”

“On the flip side,” he added, “you have the expensing of R&D, which has been a staple of the U.S. tax code for as long as any of us can remember.”

Most U.S. pharmaceuticals have significant research operations in the United States, he said, and any proposal that would eliminate expensing of R&D would create a punitive tax impact for those companies.

Lewis said the U.S. has not kept pace with the rest of the world, where R&D credits and other incentives are readily available and more reliable, and corporate tax rates much lower.

“To stay competitive with foreign competitors, we have to be in Ireland, we have to be in Puerto Rico in terms of the production and commercialization of our products,” Lewis said.

Externalities

James B. Mackie III, director of the Office of Tax Analysis with the U.S. Department of Treasury, said that the rationale for the R&D credit is supported by an economist's understanding of “externalities”—costs and benefits arising from a transaction that accrue to parties other than those directly involved in the transaction.

On the cost side, he said, pollution created by a manufacturing operation can be problematic for workers or people who live near the factory, and those costs might not be built into the price of the product.

“So you would impose a tax to correct for that,” he said.

R&D and education are often used as examples of external benefit, he said.

“This is very important in thinking about the taxation of R&D or intangibles,” Mackie said. “An individual who invents something might not be able to charge other companies for using the product, because they could backwards engineer it or they might just observe what happens and adopt similar production processes,” he said.

In theory, he said, the inducement to conduct R&D will drop off when the returns to the whole society exceed the returns to the individual investor.

“So we won't have enough investment in R&D and you might want to think about tax or other government policies to encourage R&D,” Mackie said.

External benefits associated with R&D that “spills off” are a big reason for tax subsidies, he explained, and one reason why it might not be in the best interest of the U.S. to eliminate those incentives in the name of tax reform.

However, because so many tax reform proposals focus on “tax neutrality”—the idea that income from all investments should be taxed at the same rate—policymakers need to consider the special circumstances that relate to intangibles.

Tax Neutrality

“Tax neutrality doesn't say anything about the level of taxation,” Mackie said. “It is about differences in taxation across investments or activities, and it is probably important to keep in mind that something like revenue-neutral tax reform cannot do much to lower the overall level of taxes on business income. “

Mackie cited a comparison of effective marginal tax rates (EMTR) on new investment in tangibles, such as land and equipment, and intangibles—R&D and advertising—prepared for Treasury before the R&D credit was extended. EMTR represents the present value of taxes paid as a fraction of the economic income earned over the life of “hypothetical, barely profitable” new investment, he said.

The comparison shows that the EMTR on investment in intangibles was much lower than the EMTR on investment in tangible goods. For intangibles, the EMTR was 6.2 percent for corporate investment and -3.1 percent for noncorporate business investment. In contrast the EMTR for investment in equipment ranged from 18.7 percent to 27.3 percent, and for investment in inventories, from 33.8 percent to 41.9 percent.

If the R&D credit had been included, the EMTR for investment in intangibles would be even lower, Mackie said, “somewhere around minus 20 percent—which means the investment is absolutely being subsidized.”

A low marginal tax rate on intangibles violates neutrality, Mackie said, but “neutrality does not hold when there are lots of external benefits, which there might be in R&D.”

“Some studies,” he said, “suggest that the externalities in one form or another associated with R&D are really writ quite large. Some put the total return at twice the private return although there is substantial disagreement around this.”

But pure administrative simplicity might be another reason to support a tax advantage for R&D, because it is hard to identify and capitalize those costs.

“It might be sensible in a reformed tax system to still have a tax advantage for R&D compared to other business assets,” Mackie said.

Excess Returns Proposals

He noted that President Obama's Framework for Business Tax Reform included maintaining a tax preference for R&D and advertising by continuing to expense those costs and by making the R&D credit permanent.

In addressing foreign source income from intangibles, President Obama in his 2013 budget renewed his excess returns proposal, under which the United States would treat transfers of intangibles by a U.S. corporation to a related controlled foreign corporation as subpart F income if the income were subject to a foreign effective tax rate of 10 percent or less.

The president also proposed a minimum tax rate for foreign subsidiaries of U.S. corporations as part of his Framework for Business Tax Reform.

House Ways & Means Committee Chairman David Camp (R-Mich.) has proposed similar measures—an excess returns provision and a provision to treat all earnings of CFCs as subpart F income unless they are derived in the CFC's home country or subject to a foreign effective tax rate of more than 10 percent. Camp also has a third proposal—lowering the corporate tax rate for all foreign intangible income to 15 percent while treating a CFC's foreign intangible income as subpart F income if it were taxed at a less than 13.5 percent overseas.

Third Camp Alternative

Ronald Dickel, vice president of global tax and trade with Intel, was critical of the excess returns provision, saying that it would likely create the opposite result it intends by inducing companies to move even more of their intangibles abroad. Camp's second proposal would be too difficult to administer, he added, but the third is unique among base erosion provisions in that it would provide both “carrot and stick.”

Because the proposal considers only IP income, he said, “it will disproportionately impact high-tech and pharma—but that is where the income is.”

Dickel said the proposal would create parity for U.S. corporations.Income from goods and services produced and consumed abroad would be taxed at 15 percent. Conversely, income from goods or services produced in the United States but consumed abroad also would be subject to a tax rate of 15 percent.

However, income from goods and services produced overseas but consumed in the United States would be taxed at the going U.S. corporate rate, and that would be the same rate applied to income from goods and services both produced and consumed here.

“That is an intriguing proposal for U.S. exporters and to encourage U.S. activity, to encourage companies to keep their R&D in the U.S.,” Dickel said.