

WORKING GROUP ON INTANGIBLES

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**STATEMENT OF THE WORKING GROUP ON INTANGIBLES
SUBMITTED FOR THE RECORD OF THE HEARING ON
TRANSFER PRICING ISSUES
BEFORE
THE HOUSE COMMITTEE ON WAYS AND MEANS
ON
JULY 22, 2010**

Introduction

The Working Group on Intangibles (“the Working Group”) welcomes the opportunity to provide comments for the record relating to the July 22, 2010 House Ways and Means Committee hearing on transfer pricing issues. The Working Group is composed of U.S.-based worldwide companies representing a cross-section of industries, including medical device manufacturers, food product companies, consumer nondurable goods companies, pharmaceutical companies, software companies, and health care and information technology companies. Working Group companies compete throughout the world and are engaged in the development and deployment of cutting edge technologies that are integral to products sold to consumers around the globe.

Working Group companies represent diverse industries, but they generally share several major common characteristics – they spend billions of dollars annually on research and development (“R&D”) in the United States, they sell their products to customers throughout the world, and they compete throughout the world with foreign-headquartered companies that have much more limited exposure to the U.S. tax regime. These traits require that Working Group companies take advantage of local market opportunities, while developing technologies that have the widest possible global reach. The U.S. tax treatment of intellectual property, including transfer pricing rules and rules relating to deferral, are of critical importance to Working Group companies. Legislative proposals to change those rules would have a dramatic impact on both the number and location of R&D jobs currently located in the United States and the ability of Working Group companies to compete effectively in the global marketplace.

Global commercial activity in the 21st century typically involves the use of patents, trademarks, or other intellectual property that often has substantial value independent of the underlying goods or services sold or performed (“intangibles”). The current U.S. tax rules relating to R&D and the use of intangibles, combined with the U.S. deferral rules, are critical to

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the global competitiveness of U.S. corporations. They contribute significantly to the creation of the high-paying U.S. jobs that result from our companies' successful worldwide operations and their expanding global market share. Witnesses at the July 22nd hearing discussed several proposals relating to the tax treatment of intangibles. These proposals threaten the very nature of U.S. competitiveness and innovation. First, the President's FY2011 budget proposes to end deferral for certain income derived from intangibles that are transferred by a U.S. person to a related controlled foreign corporation ("CFC"). Second, on May 18, 2010, House Ways and Means Committee member Lloyd Doggett (D-TX) introduced a bill (H.R. 5328) that would extend the anti-deferral rules of Subpart F¹ to royalty payments made by a CFC to a related CFC.

By ending deferral for certain foreign-related income derived from intangibles, these proposals would subject such income to a current U.S. corporate tax rate that is among the highest in the world. Members of the Working Group are convinced that these proposals, if enacted, would necessarily lead to significant corporate cost reduction efforts that would reduce U.S. jobs and drive the creation and development of intangibles overseas. Thus, the proposals would have the perverse impact of reducing U.S. jobs – high value, high paying research and development positions would be more likely to be located abroad to ensure that future intangibles are not developed in the United States.

These unfortunate outcomes are the natural and necessary steps that would have to be taken by U.S.-based worldwide companies if they are to remain globally competitive. Moreover, a portion of the increased tax burden on U.S. global companies triggered by these proposals would be due to increased foreign taxes (and not U.S. taxes) as U.S. companies would no longer be in a position to reduce their local taxes in a manner employed by their foreign competitors in those same markets. This increased foreign tax burden would result in greater foreign tax credits and, therefore, reductions in the U.S. tax liability with respect to such foreign earnings.

Discussion

U.S. corporations that operate overseas often are required to grant rights in or to intangibles to related foreign subsidiaries in order to function effectively in a foreign market. Indeed, Working Group members engage in a variety of activities that could be affected by the proposed changes in the treatment of income from intangibles, including manufacturing, R&D, distribution, and the provision of services. In such cases, the current law "transfer pricing" rules require the payment of adequate compensation for any grant of a right to use intangibles. Very generally, under the "arm's-length" principle that has been in use for 75 years in the United States, the adequacy of the compensation paid to a related corporation is determined by reference to comparable transactions among *unrelated* parties. The transfer pricing rules were not invented by multinational corporations to minimize their tax liability; rather, these guidelines reflect a consensus among the U.S. government and its major trading partners, in recognition of the need to properly divide income among transaction participants located in multiple jurisdictions. Indeed, the arm's-length standard is the subject of a worldwide body of law, evidenced by

¹ "Subpart F includes sections 951 through 965 of the Internal Revenue Code of 1986, as amended (referred to herein as the "Code," except as noted).

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copious and longstanding IRS regulations, U.S. court cases, bilateral tax treaties, and OECD guidelines.

Under the general U.S. rule of “deferral,” the active foreign earnings of a U.S.-owned controlled foreign corporation (“CFC”) are subject to tax on a current basis only under the laws of the foreign jurisdictions in which the CFC conducts business, with the United States deferring income taxation on such foreign earnings until those earnings are repatriated into the United States. Deferral helps protect the international competitiveness of U.S. companies by providing tax results that, on a current basis, are closer to those achieved under the territorial tax systems employed by most major trading partners of the United States, although on a permanent basis the U.S. rules continue to be significantly more burdensome than these systems of our trading partners. The anti-deferral rules of Subpart F, however, can apply to trigger a current *U.S.* tax as the result of transactions involving related CFCs. In this regard, President Obama’s FY2011 budget includes a novel proposal to end deferral for certain income from intangibles that are transferred by a U.S. person to a related CFC, under circumstances that have yet to be fully defined.² Similarly, Rep. Doggett’s bill would extend the anti-deferral rules of Subpart F to royalty payments made by a CFC to a related CFC, even where the royalties are generated by an active business.³

Like the Administration’s other proposals to curtail the longstanding deferral rules,⁴ the proposals described above would significantly increase the tax burden on American companies that employ intangibles in *routine* ways as an integral part of their business activities. The current treatment of intangibles is part and parcel of the deferral rules that have helped U.S. global corporations to remain competitive and to preserve high-paying U.S. jobs that result from their worldwide operations.

Moreover, proposals of the type described above effectively abandon the “arm's length” transfer-pricing principle that the United States has consistently promoted to such an extent that it has become the international norm. Administration officials, in arguing in support of the

² General Explanation of the Administration’s FY2011 Revenue Proposals, Department of the Treasury, February 2010 (“Treasury Explanation”) at page 43; as described, the proposal would impose immediate U.S. tax on the “excess return” from intangibles that a “U.S. person transfers...from the United States to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting.”

³ H.R. 5328 would (1) repeal the CFC look-through rule for royalties, and include a repeal of the elective entity classification (“check-the-box”) rules for the limited purposes of determining whether royalties are foreign personal holding company income; and (2) deem income from personal property to be foreign base company sales income if intangible property that contributes to production by a CFC was made available by a related U.S. person, subject to an exception for property produced directly by a CFC but without regard to check-the-box elections.

⁴ One proposal would defer interest deductions attributable to deferred foreign-source income, and another would require U.S. corporations to calculate foreign tax credits for taxes paid by their foreign subsidiaries based on the average foreign tax rate paid by all the subsidiaries. Treasury Explanation at pages 39-41.

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“excess return” proposal in the budget, maintain that it would only serve as a backstop to the arm’s-length standard. However, the proposal would effectively override the arm’s length standard by subjecting income that is properly assigned to another jurisdiction under that standard to immediate U.S. tax. This expansion of the Subpart F rules -- and a corresponding curtailment of deferral -- would be a dramatic departure from international norms, to the detriment of the competitiveness of U.S.-based worldwide companies. Enactment, of an incremental tax in cases in which intangibles transferred at arm’s-length are ultimately successful – under the President’s proposal – with no correlative adjustment where such intangibles are not successful, would create a clear incentive for U.S. companies to move the development of intangibles to jurisdictions that provide equitable treatment for both income and losses (i.e., countries that consistently apply the arm’s length standard).

Members of the Working Group have granted rights in or to intangibles to their related foreign subsidiaries in order to function in global markets and compete against foreign-based multinational corporations. Rights to use intangibles are not granted casually, and the granting of such rights is usually required to facilitate multi-source manufacturing, and to obtain protection under trademark, patent, or other applicable law, quite apart from tax considerations. Furthermore, such grants or transfers must be done in compliance with all applicable laws and regulations, not just U.S. transfer pricing rules. In the case of a global business, rights to intangibles must be granted across the worldwide affiliated group of corporations – with arm’s length compensation provided for the functions performed, risks borne, and investments made by each such corporation.

Conclusions

The transfer and collaborative use of intellectual property are necessary components of modern business practices. Transfer pricing for these transactions involves intricate business decisions that are made in the context of increasingly complicated U.S. international tax rules. These transfers relate both to U.S. developed intellectual property used by foreign affiliates as well as foreign developed intellectual property used by U.S. affiliates. It is vitally important that policy makers seriously consider the broad consequences of the excess returns proposal, and the potential impact of the proposal on high-paying U.S. jobs relating to R&D and the development of intellectual property.

Accordingly, policy makers would be better served by focusing their efforts on reforming the U.S. international corporate tax regime in a manner that is consistent with international norms, including reducing the corporate income tax rate. The Working Group looks forward to assisting members of the Ways and Means Committee and their staffs gain a more detailed understanding of the business practices that are necessary for our companies to compete globally, and the tax consequences of these practices. We are hopeful that this hearing will serve as an impetus for a thorough examination of much needed comprehensive reform of the U.S. international tax regime, rather than the development of piecemeal proposals that would produce unintended negative results for U.S. companies, U.S.-based R&D jobs, and ultimately U.S. competitiveness.

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