

**PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE
INCOME SHIFTING AND TRANSFER PRICING**

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on transfer pricing issues on July 22, 2010. This document,¹ prepared by the staff of the Joint Committee on Taxation and submitted to the House Committee on Ways and Means, includes a background discussion of business restructuring, a description of past and present law relevant to the studies, and six case studies of U.S.-based multinational corporations and how the business structure of those corporations interacts with the Internal Revenue Code to determine the corporation's U.S. tax liability.

As summarized below, some studies suggest that multinational enterprises (both U.S.-based and foreign-based) may be able to shift income to low-tax jurisdictions, suggesting deficiencies in the application of transfer-pricing rules. While perhaps suggestive, these studies do not identify the mechanisms by which income shifting might occur. The majority staff of the House Committee on Ways and Means inquired of the staff of the Joint Committee on Taxation ("Joint Committee staff") whether case studies might be developed, perhaps relying on public information, to identify business structures that facilitate possible income shifting or deficiencies in the application of transfer-pricing rules. The Joint Committee staff concluded that public information alone would prove insufficient, but that a review of public and private documents for specific taxpayers might help explain how the interaction between business operations and tax planning could result in low reported average U.S. and worldwide tax rates by some taxpayers.

The Joint Committee staff selected six U.S.-based multinational corporations to study, in part, on the basis of reports to their shareholders that each of the corporations had an effective (i.e., average) tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999. The six case studies do not represent a random selection of U.S.-based multinational corporations. The Joint Committee staff's discussion of issues is based upon the facts as reported and is not a commentary on the correctness of any specific position taken by the taxpayer. The Joint Committee staff does not view the case studies as an investigation of the tax position of any specific taxpayer, but rather views the case studies as facilitating the identification and discussion of business structures that may affect a taxpayer's U.S. and worldwide tax liability.

Cross border investment

Growth in cross border trade and investment

Cross-border trade in goods and services has increased substantially over the past 50 years (Figure 1). Many U.S. persons owe their present employment to businesses that import goods for final sale in the United States or import component parts for further manufacture in the United States. Likewise, many U.S. employers produce goods and services for direct final sale

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010. This document is available on the internet at www.jct.gov.

abroad or for sale as a component for further manufacture abroad. Significant portions of both exports and imports involve sales between related parties.

At the same time, foreign direct investment by U.S. persons, that is the direct ownership of greater than 10-percent interests in assets located abroad has grown steadily over the past 50 years as has foreign direct investment in the United States (Figure 2). “Outbound” foreign direct investment occurs when a U.S. person acquires an existing foreign business or when a U.S. person invests in business operations abroad. Almost by definition, multinational corporations engage in foreign direct investment as they acquire or create assets abroad to manufacture or sell the corporation’s goods and services.

There are many reasons that may motivate a U.S. multinational corporation to make an outbound foreign direct investment. Building a plant abroad may be the most cost efficient way for a U.S. multinational corporation to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market via direct export from a U.S. location. Foreign direct investment may put the U.S. multinational corporation physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market, which can serve as the basis for improved future marketing of goods and services. A U.S. multinational corporation may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor, less expensive access to important raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. In addition, foreign direct investment may provide access to foreign-developed technology. Tax burden is another factor that may motivate foreign direct investment by U.S. multinational corporations. While not dismissing the other possible factors, the purpose of this pamphlet is to discuss some of the possible roles that taxes may have in foreign investment decisions by multinational corporations.

Figure 1.—U.S. Exports and Imports 1960-2009
 [Millions of Real 2009 Dollars]

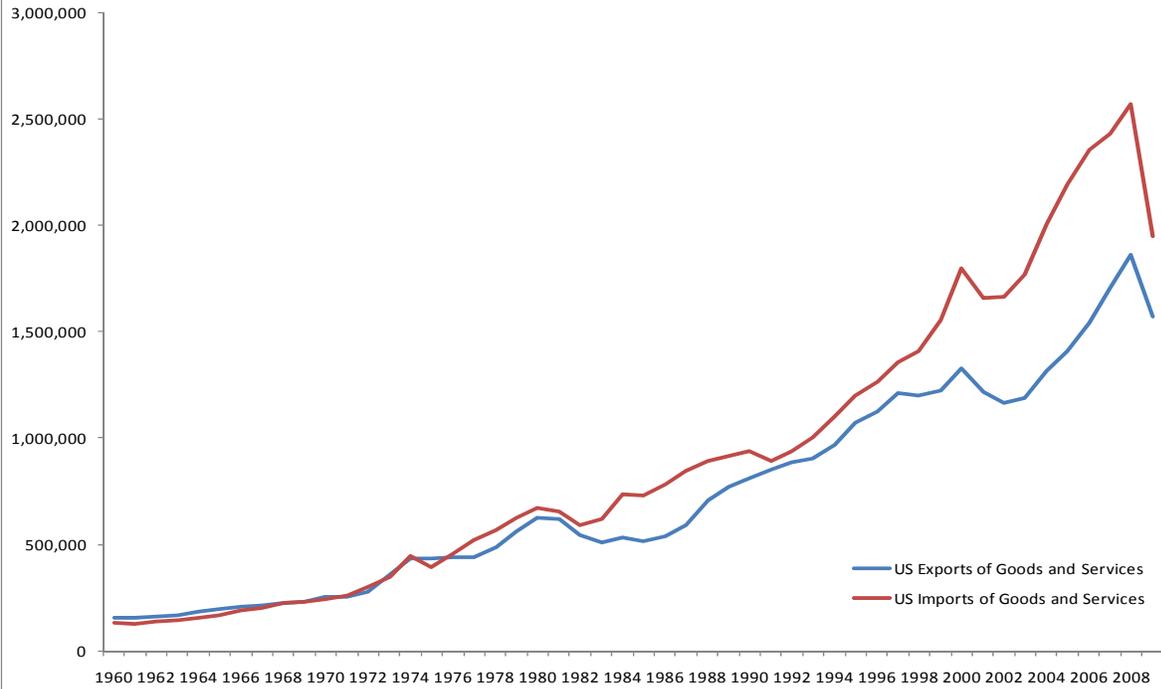
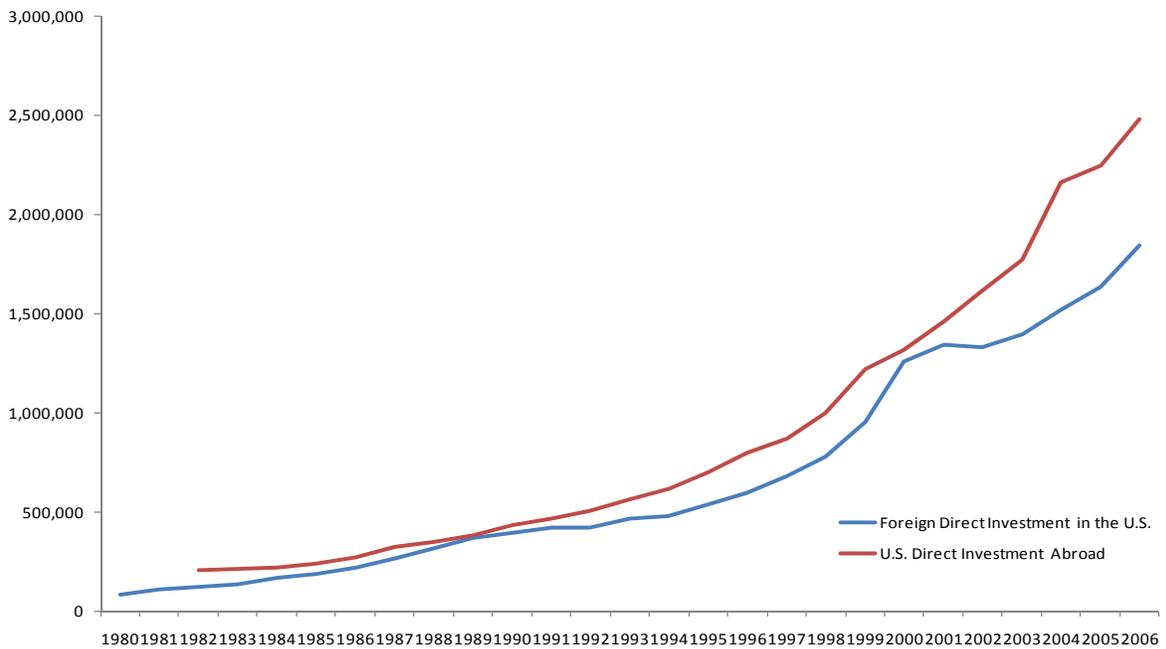


Figure 2.—Value of U.S. Direct Investment Abroad and Foreign Direct Investment in the U.S. on an Historical Cost Basis, 1982-2006
 [Millions of Real 2009 Dollars]



Consequences of outbound foreign direct investment

Outbound foreign direct investment could affect U.S. employment, domestic investment, U.S.-based research activities, and long-run economic growth. Outbound foreign direct investment could affect U.S. employment in different directions. If the investment in a facility abroad is in lieu of a domestic facility that would serve the same foreign customers from the United States, U.S. employment would decline. On the other hand, a U.S. based multinational corporation may manufacture components of a product which are shipped to a foreign affiliate for further manufacture or sale in a foreign market. If this is part of a business plan to increase foreign sales, the increased sale of finished goods may increase domestic employment in the manufacture of components. There is no definitive conclusion about the effect of outbound investment on U.S. employment. One survey of the empirical literature concludes, “[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm’s home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment”² However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

Likewise, empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement to domestic investment. Generally, these studies have found either no effect or a positive effect of overseas production in a host-country market on home-country exports to that market. One survey reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates \$0.16 of exports from the United States.³ The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the U.S. parent firm shifts to more capital intensive and skill intensive domestic production.⁴ Similarly, foreign direct investment may change the amount or location of research activities.

Changes to domestic employment, investment, and research, may affect future economic growth. Hence, ultimately, the tax base could be affected. This pamphlet will explore whether the structure and location of outbound foreign direct investment may alter the U.S. income tax base in ways other than through the change in economic growth that might result from changes in the macroeconomic factors of employment, investment, and research.

² Robert E. Lipsey, “Outward Direct Investment and the U.S. Economy,” in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, “Are U.S. Multinationals Exporting U.S. Jobs?” in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets*, Elgar, 2001.

³ Robert E. Lipsey, “Outward Direct Investment and the U.S. Economy.” In later research, Lipsey reaches similar conclusions. Robert E. Lipsey, “Home and Host Country Effects of FDI,” in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization*, (Chicago: University of Chicago Press), 2004, at 333-379.

⁴ Lipsey, “Home and Host Country Effects of FDI.”

The U.S. income tax system and the U.S. tax base

Overview of taxation of the active foreign business earnings of U.S. companies

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Income earned in the United States directly or through a pass-through entity (such as a branch) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly mobile income. One of the main anti-deferral regimes is the controlled foreign corporation⁵ (“CFC”) rules of subpart F of the Code.⁶

The United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a foreign controlled party through inappropriate pricing of related party transactions. The statutory authority for those rules is found in section 482, and the principal measure by which that authority is exercised is the arm’s-length standard.⁷ The term “transfer price” refers to the price at which one company sells goods or services to a related affiliate in its supply chain. Thus, “transfer pricing” is the system of laws and practices used by countries to ensure that goods and services transferred between related companies are appropriately priced, based on market conditions, such that profits are correctly reflected in each jurisdiction. The principal tax policy concern is that profits may be artificially inflated in low-tax countries and depressed in high-tax countries through aggressive transfer pricing that does not reflect an arm’s-length result from a related-party transaction.

Incentives to earn income in low-tax jurisdictions

Deferred taxation of active foreign earnings provides an incentive for U.S.-based multinational corporations to earn income abroad if that income is attributable to an active business in a lower-tax foreign jurisdiction.⁸ If foreign earnings are taxed at a rate lower than

⁵ A CFC is defined generally as a foreign corporation with respect to which U.S. shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation. Sec. 957(a). A U.S. shareholder is any person with a 10-percent or greater interest. Sec. 951(b). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

⁶ See secs. 951-965.

⁷ Treas. Reg. sec. 1.482-1.

⁸ U.S. Generally Accepted Accounting Principles (“GAAP”) financial accounting rules permit a taxpayer to reflect (on an accrual basis) the difference between the U.S. tax rate (generally 35 percent) and the foreign tax rate paid on that deferred income as a benefit for financial statement purposes. To record the financial statement benefit, the taxpayer must demonstrate, to the satisfaction of its external auditor that it intends to permanently reinvest those

that which would apply in the United States and if the applicable residual U.S. tax (tax imposed on the difference between the low foreign rate and the U.S. rate) is deferred, a U.S.-based multinational corporation can increase the after-tax return to its shareholders because the present value of the tax liability declines the longer the deferral period.

There are many nontax motivations for foreign direct investment. However, if a taxpayer has made an investment abroad and that investment is in a country with a tax rate lower than that of the United States, it can be to the taxpayer's advantage to attribute as much income as possible to that investment in order to exploit the possible benefit of deferral. This may put pressure on the determination and administration of the transfer pricing rules.

Trends in the U.S. tax base

As noted above, there are multiple potential benefits to a taxpayer from making a foreign direct investment. Any particular investment need not be tax motivated. However, once an overseas investment is contemplated, it is rational for the taxpayer to organize the taxpayer's business to attain as high an after-tax return to investment as possible. There is empirical evidence that U.S. multinational corporations shift income to low-tax foreign jurisdictions.

The Government Accountability Office ("GAO") reported in 2008 that the average tax rates on the foreign operations of U.S. multinationals vary considerably by country, and that most of the countries studied with relatively low average tax rates have income shares significantly larger than their shares of the business measures that are relatively easier to value: physical assets, compensation and employment. The GAO found that the opposite relationship holds for most of the high tax countries that it studied.⁹

In 2007, a Treasury Department study of the effectiveness of the transfer pricing rules examined the relationship between CFC profitability (measured by the ratio of operating profits to sales) and the statutory tax rate of the CFC's jurisdiction.¹⁰ In general, if a multinational group is engaging in non-arm's-length pricing to shift income to low-tax jurisdictions, one would expect to observe higher CFC profitability in low-tax jurisdictions and lower CFC profitability in

funds outside of the United States. The greater the difference between the U.S. tax rate and the foreign tax rate paid on deferred income, the greater the benefit to a taxpayer's U.S. "book tax" savings and the higher its reported earnings per share.

⁹ United States Government Accountability Office, *U.S. Multinational Corporations, Effective Tax Rates Are Correlated with Where Income Is Reported*, Report to the Committee on Finance, U.S. Senate, August, 2008.

¹⁰ U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, citing Michael McDonald, "Income Shifting from Transfer Pricing: Further Evidence From Tax Return Data," *OTA Technical Working Paper 2*, July 2008. This report was issued in response to a direction from Congress in 2004 that the Treasury Department conduct a study of the effectiveness of the transfer pricing rules and compliance efforts related to cross-border transfers and other related-party transactions. Congress requested that the study focus particularly on transactions involving intangible assets, service contracts and leases that may be used improperly to shift income out of the United States. American Jobs Creation Act of 2004, Public Law No. 108-357 sec. 806.

high-tax jurisdictions, assuming other factors are equal.¹¹ Using information from tax filings for the years 1996, 2000 and 2002, the study found an inverse relationship between pre-tax profitability and tax rates.¹² In other words, the data generally showed that pre-tax operating margins are higher in low-tax countries and lower in high-tax countries.¹³ Based on this analysis, the Treasury study concluded that there is some potential for income shifting under the current regulations, and that this potential is perhaps most acute with respect to cost-sharing arrangements involving intangible property. The Treasury study acknowledges, however, that many factors affect profitability, and that while the results are consistent with income shifting, a more refined empirical analysis is necessary to isolate income shifting through non-arm's-length pricing.

The GAO and Treasury findings are consistent with those of empirical studies conducted by economists, beginning in the early 1990s and continuing through today, which include controls for various non-tax factors.¹⁴ For example, one study using aggregated country-specific data and adjusting for financial structure and capital employed, found that evidence of sensitivity of profitability to local country tax rates.¹⁵ A second study, using firm-level data based on public (non-tax) filings of publicly traded companies, found that evidence of income shifting out of or into the United States correlated with tax-rate differentials between the United States and foreign jurisdictions, taking into account company characteristics such as research expenditures and advertising (as proxies for intangibles), interest expense and number of employees.¹⁶ A 2006 study comparing Treasury data for manufacturing subsidiaries in 1996 and 2000 indicates that

¹¹ U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 57.

¹² *Ibid.*, p. 58. See also Martin A. Sullivan, "Extraordinary Profitability in Low-Tax Countries," *Tax Notes*, (August 25, 2008), p. 724 (analyzing IRS Statistics of Income Bulletin data for 2004 on related foreign corporations and concluding similarly that manufacturing subsidiaries of U.S. corporations in low-tax countries have high profitability, while manufacturing subsidiaries in high-tax countries have low profitability).

¹³ U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 57. For purposes of the study, operating profits were defined as pre-tax earnings, excluding interest income and interest expense. *Ibid.* "The measure is based on 'earnings and profits' and is intended to approximate 'book' operating profits for tax purposes." *Ibid.* Financial CFCs and CFCs with losses were excluded. *Ibid.*, note 72.

¹⁴ *Ibid.*, pp. 59-62. See also, Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, 221, Vol. LVI, No.1, Part 2, (March 2003) p. 226 (citing several studies); Reuven S. Avi-Yonah and Kimberly A. Clausing, "A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project," Public Law and Legal Theory Working Paper Series, Working Paper No. 85 (June 2007).

¹⁵ James R. Hines, Jr. and Eric Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics*, 109 (February 1994), p. 149.

¹⁶ David Harris, Randall Morck, Joel Slemrod, and Bernard Yeung, "Income Shifting in U.S. Multinational Corporations," in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds., *Studies in International Taxation*, (Chicago: University of Chicago Press), 1993.

income shifting has increased.¹⁷ While not conclusive evidence of income shifting through non-arm's-length pricing, these studies suggest that foreign investment by U.S. taxpayers may be accompanied by erosion of the U.S. tax base.

Other observers have looked at the growth of cross-border trade and foreign direct investment (both outbound and inbound) and have questioned whether the U.S. income tax base is reflecting this growth. Table 1 presents some simple comparisons. The first two entries in Table 1 compare the annual rate of growth for the period 1996-2006 in the value of U.S. exports of goods and services to the annual rate of growth in the value of exports of goods and services from U.S. parent businesses to their foreign affiliates. The rate of growth in the value of traded goods and services from U.S. parents to their foreign affiliates is approximately 1.75 percentage points lower than the rate of growth for the overall economy. By this calculation, exports by multinational enterprises were a declining share of total exports during this period. This could arise if exports by unaffiliated business grew more rapidly than other sources trade or if multinational enterprises reduced their use of affiliates for export sales. The difference in export growth rates could be consistent with attempts to shift value and income out of the United States by multinational enterprises. However, the annual growth rate of imported goods and services from the foreign affiliates of U.S. parent enterprises also lagged the growth rate of total annual imports by approximately 1.75 percentage points per year. One might not have expected commensurate decline in the growth of the value of imports as imported value is a cost to the domestic sale of the imported good or service by the U.S. parent.

The third and fourth entries in Table 1 compare the annual growth in total U.S. income from U.S. foreign direct investments to the annual growth in earnings reinvested abroad by foreign affiliates of U.S. parents.¹⁸ Income growth reinvested by foreign affiliates of U.S. parent enterprises grew approximately 2.75 percent faster than the income from the average U.S. outbound foreign direct investment. This could occur if the investments made by U.S. multinational enterprises are more successful than the average investment made outside the organization of a multinational enterprise. Some of the most successful domestic businesses attempt to expand their expertise abroad. This could explain the higher growth rate in affiliate earnings. Faster growth in affiliate earnings may also be consistent with attempts to shift value and income out of the United States by multinational enterprises.

¹⁷ Grubert and Altshuler, "Corporate Taxes in the World Economy," pp. 339-340.

¹⁸ Reinvested earnings of foreign affiliates as reported by the Bureau of Economic Analysis for the National Income and Product Accounts are not the same measure as those reported for U.S. GAAP financial accounting.

Table 1.—Annual Nominal Growth Rate of Exports from U.S. Parents to Foreign Affiliates and the Nominal Growth Rate of Reinvested Earnings by Foreign Affiliates, 1996 - 2006

	Total for the United States Exports of Goods and Services	Exports from U.S. Parents to Foreign Affiliates	Income from U.S. Foreign Direct Investment	Reinvested Earnings of Foreign Affiliates of U.S. parents
Annual Rate of Nominal Growth, 1996-2006	5.48%	3.72%	12.51%	15.33%

Source: Joint Committee staff tabulations of Bureau of Economic Analysis data.

The aggregate trade data also document that since the mid-1990s there has been a decline in the U.S. content of sales to unrelated parties by foreign nonbank affiliates of U.S. parents, while the converse measure (the foreign content of sales to unrelated parties by the U.S. nonbank affiliates of foreign parents) has changed little. This relative decrease in U.S. content could have a negative effect on the U.S. tax base to the extent that U.S. content is correlated with U.S. wages and U.S. profits. Because of the large and growing volume of trade, small relative changes in content percentage could have significant tax base effects.¹⁹

Factors that could lead to an erosion of the U.S. tax base

There are many factors that may contribute to the empirical findings reviewed above. Taxpayers may reduce their U.S. tax base by organizing their worldwide business to concentrate a significant portion of their more profitable functions offshore in jurisdictions where the average tax rate is low and a significant portion of their more routine and less profitable functions in jurisdictions where the tax rate may be higher. Ownership and responsibility for continued development of intellectual property rights may be centralized in a foreign jurisdiction where the average corporate income tax rate is relatively low as a result of either the jurisdiction having a low statutory corporate income tax rate or the local entity receiving a favorable tax ruling or entering into an advanced pricing agreement with the local tax authorities. Similarly, the responsibilities of the foreign principal (the legal entity that is designated as the multinational corporation's risk taker, either on a global or regional basis) may be located in a jurisdiction that also has a low average corporate income tax rate. In contrast, the taxpayer may organize its worldwide operations such that more routine and less profitable functions such as serving in the capacity of a contract manufacturer or serving as a limited risk buy-sell distributor are located in

¹⁹ Bureau of Economic Analysis, U.S. Department of Commerce, <http://www.bea.gov/international/xls/1982-2008table.xls>. For example, the U.S. content of unrelated sales by foreign affiliates of U.S. parents was 12.52 percent in 1996 and 8.69 percent in 2006, while the foreign content of sales by U.S. affiliates of foreign parents was 16.86 percent in 1996 and 17.4 percent in 2006. One caution with respect to these data is that both content percentages may be overstated because the content of intermediate purchases from unrelated parties is not identified (see footnotes 2 and 4 in the cited table).

jurisdictions where the average tax rate may be higher. This results in a lower tax base being subject to higher tax rates.

Some observers suggest that a taxpayer's ability to locate its intangible capital in low tax jurisdictions may lead to a reduction in the U.S. tax base. A taxpayer may be able to (1) have a foreign affiliate enter into an agreement with the U.S. group to buy in to the pre-existing foreign or worldwide territorial rights to exploit the intellectual property rights (e.g., make-sell rights) attributable to certain product lines and share the cost of future development of those intellectual property rights, or (2) have the foreign affiliate enter into a license agreement with the U.S. group to make and sell certain product lines either solely in non-U.S. territories or worldwide.

Taxpayers may defer their foreign earnings from U.S. taxation by effectively managing their exposure to the U.S. subpart F rules. First, where the intellectual property rights are owned by an entity in a jurisdiction that differed from the entity that served as the principal, the check-the-box rules may permit the royalty payment made from the principal to the owner of the intellectual property rights to be disregarded so that it does not trigger the subpart F foreign personal holding company income rules. Second, where the principal entity has related party sales to U.S. or foreign affiliates, the taxpayer may attempt to establish that the principal meets the manufacturing exception to subpart F foreign base company sales income.

This pamphlet examines in more depth a number of possible business structures in conjunction with the rules that define the U.S. income tax base. Part One of this document describes business restructuring. Part Two describes relevant prior law and present law relating to transfer pricing, Subpart F income inclusions, entity classification, and relevant prior law related to section 936 possession corporations. Part Three describes six case studies prepared by the Joint Committee staff to illustrate the tax base effects of business structures and transfer pricing. Part Four provides a discussion of issues and analysis relating to the case studies presented.

In reviewing the case studies, the reader should be aware that the studies are not intended to be comprehensive. As a result, they do not address every issue that may be present in a particular case, nor do they collectively present every issue that may arise with respect to the tax treatment of intangibles. For example, the treatment of interest or stewardship expenses is outside the scope of this pamphlet, as is earnings stripping and the application of section 163(j). Similarly, the operation of the Advanced Pricing Agreement program, and the administrability of the transfer pricing rules in general are outside the scope of this pamphlet.

I. BUSINESS RESTRUCTURING

Introduction

The term “business restructuring” generally refers to the realignment of functions and risks between various entities in the supply chain. Although restructuring is not a modern phenomenon, the Organization for Economic Cooperation and Development (“OECD”) has recently studied the tax aspects of the business restructurings that companies (both U.S.- and foreign-based) have undertaken over the past 20 years. The OECD observed that –

A common pattern clearly emerged with businesses, regardless of their products or sectors, increasingly reorganizing their structures to provide more centralized control and management of manufacturing, research and distribution functions. The pressure of competition in a globalized economy, savings from economies of scale, the need for specialization and the need to increase efficiency and lower costs were all clearly important driving business restructuring.²⁰

Restructurings are often undertaken in conjunction with some other business event or organizational shift. For example, the integration of a recently acquired company, a report from an external business consulting firm, or even the decision to make substantial changes in the company’s information technology systems may prompt a company to consider a business restructuring. Because many business effectuated over the past 20 years have involved moving business functions and risks to low-tax countries and shifting income out of high-tax countries (including the United States), some view business restructurings as comparable to tax shelters, “mainly designed to reduce taxes.”²¹

The supply chain

A taxpayer’s supply chain is the system that moves a product or service from supplier to customer. From a tax perspective, the definition of a supply chain incorporates the legal entities (which own technology, information, and other resources) and the contractual relationships between those legal entities that govern the terms of moving the product or service from entity-to-entity as it progresses from supplier to customer. The supply chain may include entities that are related parties, unrelated parties, or both. If the product sold to the end customer is complex and comprised of many components sourced from multiple jurisdictions, the supply chain may include multiple related – and possibly unrelated – party transactions. The role of transfer pricing is to ensure that each entity participating in the supply chain is appropriately

²⁰ Organization for Economic Cooperation and Development, *2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring*, available at http://www.oecd.org/document/20/0,3343,en_2649_37989760_34535252_1_1_1_1,00.html.

²¹ Lee Sheppard, “Downturn Pokes Holes in Business Restructurings,” *Tax Notes*, (Mar. 22, 2010), at 1436.

compensated for the contribution it makes to the production of the good or service based on the arm's-length standard.

To understand the business restructurings being undertaken, it is helpful to compare a modern restructured company to the typical business structure of a multinational corporation of 60 years ago. Then, it was more typical for a U.S. company to serve its market through a self-contained supply chain, from product development through manufacture and delivery of finished goods to the end U.S. customer. Multinational companies would typically have full-risk operating subsidiaries in each foreign jurisdiction, as well as some foreign manufacturing and distribution operations. Each foreign subsidiary functioned as its own self-contained unit, with a local equivalent of a chief executive officer, chief financial officer, and supporting staff. Manufacturing, distribution, and marketing decisions were typically made locally, but were often based on financial targets imposed by the home office. All risks of the local country operation were generally born by the subsidiary, whether the local operations were commercial or manufacturing in nature.

Implicit in these multinational structures was redundancy — the infrastructure in each foreign subsidiary a mirrored image of the others, scaled to reflect the magnitude of the market being served or operations being undertaken. In some cases, the services in the supply chain may have been provided in a particular location based more on historical precedent than on strategic planning. For example, this may have occurred if a U.S. company acquired a business with a factory in Germany, but then never subsequently considered whether Germany was, in fact, an optimal location for that factory. In addition to operating the factory, the German subsidiary may have also been the distribution center for Germany, and possibly served as a regional distribution hub. The presence of independent operating subsidiaries may also have been dictated by the economics of transportation costs and trade barriers between countries.

The modern supply chain, too, may also begin with the conceptual development of a product and extend through the delivery of finished goods to the end customer, but it is more apt to be characterized by specialization, by function, of entities and operations, with less duplication country to country. Some entities in the network may specialize in the manufacture of components or finishing, and others may specialize in the marketing or distribution of finished products. Entities that manufacture various components of a product may be located in different countries and in countries different than from those in which finish manufacturing is performed. The entity that performs finish manufacturing may reside in a country other than that of the entity that manages distribution. Finally, the entity that manages distribution may reside in a country that is different from that of the entity that facilitates the sale to the end customer.

The multinational's goal, generally, is to operate as efficiently as possible and produce as large of a net return to its investors as possible. The taxpayer's "system profit" with respect to each product is determined by taking into account the final selling price and all costs incurred along the supply chain, then eliminating the results of intercompany transactions. However, each intercompany transaction has legal, financial, and income tax significance. When the purchasing and selling entities are located in different taxing jurisdictions, the top-line transfer price directly impacts bottom-line net taxable income in each jurisdiction.

The OECD has characterized business restructurings as comprised of a combination of four distinct components:

- Conversion of distributors into limited-risk distributors or commissionaires of a related party that may operate as a principal;
- Conversion of manufacturers into toll or contract manufacturers of a related party that may operate as a principal;
- Rationalization and/or specialization of operations such as manufacturing sites, research and development activities, sales, and services; and,
- Centralized ownership of intangible property rights.²²

The subsequent discussion explains these four components and identifies the aspects of each component that may alter the income tax liability of the taxpayer.

Components of business restructuring

In general

As noted above, there are many nontax reasons a U.S. taxpayer may locate part of its supply chain in foreign jurisdictions. An important income tax consequence of such an organizational decision is that the taxpayer's total income accrues in multiple taxing jurisdictions. To the extent that a U.S. taxpayer can structure its supply chain to result in the location of more of its income in low-tax jurisdictions, and also defer from residual U.S. tax on such income, the taxpayer will increase its after-tax return to investors.

For many multinational companies, profitability is created by exploiting intangible property, be it patented products or processes, brand names and goodwill, or management acumen. Such intangible property may enable the taxpayer to earn returns above those normally available in competitive markets. Consequently, if intangible property is a significant source of the taxpayer's income, to the extent the taxpayer can structure its supply chain to locate profit from its intangible property in a low-tax jurisdiction in a manner that avoids current U.S. taxation under the subpart F rules, the taxpayer will increase its after-tax return to investors.

The OECD has identified that a common element in business restructurings is to create a single entity as the "principal"²³ or "entrepreneur" with economic ownership of the taxpayer's intangible property. The principal oversees the development, production, and sale of goods, either globally or in a designated region. Intangibles, key functions, and risks are centralized in the principal to streamline operations and create economies of scale. Because the principal has the economic ownership of the intangible sources of the taxpayer's profitability and oversight of

²² Organization for Economic Cooperation and Development, "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment, 19 September 2008 to 19 February 2009," par. A.1, 6.

²³ "Principal" is often used interchangeably with "entrepreneur." This pamphlet adopts "principal."

the other key functions, the principal is entitled to the bulk of the system profits. Therefore, to optimize after-tax system profits, the principal is organized in a low-tax jurisdiction.

The principal may be entitled to a higher proportion of system profits if it has, in substance as well as in form, the requisite functions and risks. The principal may take on the key elements of strategic management, purchasing, production scheduling, inventory management, quality control, risk management, and strategic marketing. In addition, to increase the principal's share of system profits, the principal holds the right to exploit the valuable intangible property of the company, whether it acquired that right through a direct acquisition from an unrelated party, self-development, cost sharing, or licensing. The principal may also establish a captive research and development center to expand and manage its portfolio of intangible property. Other entities in the supply chain are designated to provide manufacturing, support (such as administrative functions), and distribution services.

Distributor conversion

With most of these structures, the principal is responsible for the sale, but it does not perform the sales function. As a consequence, foreign subsidiaries of the taxpayer may be converted into low-risk distribution service entities (limited-risk distributors, commissionaires, and/or commission agents), or the taxpayer may form new entities to provide for product distribution to serve expanding markets. Converting and limiting the role of an existing foreign subsidiary permits the interface between customers and that subsidiary to remain intact. In substance, however, the foreign subsidiary may be doing little more than facilitating the sale and delivery of finished goods and the collection of payment after the conversion.

As a limited-risk distributor, the foreign subsidiary may maintain responsibility for: (1) foreign distribution channels; (2) maintaining and developing the local sales force; and (3) maintaining relationships with foreign customers. In contrast, the principal may take over certain sales functions such as: (1) credit and collection of the company's receivables (or the risk thereof); (2) review of the company's sales performance against targets; (3) pricing, credit policies, product allocations and budgeting; (4) setting guidelines for terms and pricing, and approving exceptions; (5) establishing standard sales contracts; and (6) regional or global sales strategies. Because the principal takes on this role either on a regional or global basis, country-by-country redundancies are eliminated, and the sales functions can be streamlined.

Like a limited-risk distributor, a commissionaire sells in its own name, invoices customers, and may have some limited ability to determine prices within specified limits. In contrast, the commissionaire sells for the account of the principal, while the limited-risk distributor sells on its own account. As such, the commissionaire does not take title or hold inventory with respect to the goods it sells, whereas the limited-risk distributor does both. Because the commissionaire is not selling on its own account, the commissionaire reports only its commissions as revenue.

Implicit in the conversion is that each foreign subsidiary is entitled to a smaller allocation of the system profits as a limited-risk distributor or commissionaire than it earned as a full-risk distributor because of the limitation of its risk and because it acts at the direction of the principal. A new set of comparables must be identified to establish the appropriate return to each

subsidiary under the appropriate transfer pricing rules. Whether any compensation is due to a foreign subsidiary upon the conversion depends on the facts and circumstances, as well as the applicable laws of the country from which functions and risks were transferred. On the other hand, if the principal does not, in substance, take on the risks and functions in the same manner, and to the extent described by, the contractual agreement (i.e., the substance does not match up to the form), then little or no change in the transfer pricing may be appropriate.

Contract manufacturing conversion

Implementing a contract manufacturing conversion may also be accompanied by identification of one entity in the supply chain as the principal. If so, the principal then establishes a contract manufacturing arrangement with a second entity, usually an existing full-risk manufacturing subsidiary of the taxpayer. After the conversion, the former manufacturing subsidiary is a low-risk service provider that operates at the direction of the principal. Functions and risks that are centralized in the principal may include: manufacturing oversight; ownership of raw materials, work-in-progress, and finished goods; material and vendor selection; logistics; quality control; and the direction of the development; ownership or control of the intangible property related to the product that is being manufactured.

Centralizing risks and functions in the principal may achieve savings by promoting the efficient allocation of resources. For example, moving production decisions out of the foreign subsidiary eliminates the potential that local-country biases influence local decisions, such as production scheduling and supply sourcing, and helps ensure that global company production matches expected global market demand. Centralized procurement may allow the company to achieve economies of scale that may not otherwise be attainable. In addition, centralized operations may make it more cost effective to deploy and maintain modern communication and information technologies.

Implicit in the conversion is that a contract manufacturer is entitled to a smaller allocation of the system profits as a contract manufacturer than it was as a full-risk manufacturer because it bears little or no risk and acts at the direction of the principal. A new set of comparables must be identified to establish the appropriate return to contract manufacturer under the applicable transfer pricing rules. Whether any compensation is due to the foreign subsidiary upon the conversion would depend on the facts and circumstances, as well as the applicable laws of the country from which functions and risks were transferred. On the other hand, if the principal does not, in substance, take on the risks and functions in the same manner, and to the extent described by, the contract manufacturing agreement (i.e., the substance does not match up to the form), then little or no change in the transfer pricing may be appropriate.

Rationalization and/or specialization of operations

A principal in a supply chain takes over the multinational group's high-value functions as part of a business restructuring. For example, research and development activities may be undertaken directly by the principal, or as a service provided on behalf of, but at the direction of, the principal. The principal takes responsibility for any country-specific marketing research that was undertaken by the foreign subsidiary before the business restructuring. For example, the principal may develop and define global marketing strategies, arrange research projects, provide

funding and translate global strategies into customized local marketing and business plans. To the extent the foreign subsidiary is involved in local marketing research, after the restructuring this activity takes place under the express guidance, and direction of, the principal. Similarly, the principal exercises logistical oversight, exercises financial and operational control over inventory, retains title to inventory until delivered to the end customer, and coordinates the interaction of demand planning with supply planning.

In contrast, low-value services are typically outsourced after the business restructuring, either to unrelated persons or to foreign subsidiaries. For example, a foreign subsidiary might be a designated regional distribution and warehouse hub, with responsibility for security, inspection, short-term demand scheduling and vendor management.

Manufacturing sites that no longer fit with the strategic plan of the company may be closed in a business restructuring. Similarly, new facilities may be opened in other locations, closer to growing markets. In addition, a business restructuring presents the opportunity for a company to aggregate resources dedicated to a single purpose in one location. For example, steps may be taken to aggregate resources in a location near a university known for its research in the relevant field, and that is known for a high concentration of leading experts, or near a cluster of similarly specialized companies that has attracted a knowledgeable workforce to that particular area.²⁴ In some cases, however, planned reductions in headcount and facilities do not materialize, and personnel do not actually move to locations where operations were intended to have been centralized.

Implicit in the restructuring is that each foreign subsidiary from which functions and risks have been transferred is entitled to a smaller allocation of the system profits for the remaining services it performs because it bears less business risk and acts at the direction of the principal. As a result, new sets of comparables need to be identified to establish the appropriate returns to each foreign subsidiary, for whatever remaining services are performed, under the applicable transfer pricing rules. Whether any compensation is due from the principal to any foreign subsidiary with respect to these types of conversions depends on the facts and circumstances, as well as the applicable laws of each country from which functions and risks have been transferred. On the other hand, in any situation in which the principal does not, in substance, take on additional business risks and functions, then little or no change in the transfer pricing may be required.

Centralized ownership of intangible property rights

A key element of a business restructuring is the centralization of intangible property rights, typically in a low-tax jurisdiction. Even prior to the enactment of Tax Reform Act of 1986, some taxpayers were already engaging in business restructurings in which valuable intangible property was transferred to a foreign subsidiary – organized in a low-tax jurisdiction –

²⁴ An example of a cluster of specialized companies is Warsaw, Indiana. Despite its population of less than 13,000 people, Warsaw is home to a several orthopedic equipment manufacturers and claims to be the “Orthopedic Capital of the World.” See <http://www.todaysmachiningworld.com/welcome-to-warsaw-indiana%E2%80%99s-orthopedics-capital-of-the-world/>.

through cost sharing arrangements. In these arrangements, the U.S. company effectively transfers certain intangible property rights (by making them available for use in research and development) to a foreign subsidiary in exchange for a taxable payment, and collectively the U.S. company and the foreign subsidiary share the cost of developing marketable products from subsequent generations of the original intangible property. If priced correctly, the buy-in payment to the U.S. company – whether paid in the form of a royalty or in a lump sum – should equal the net present value of the intangible property rights transferred. On the other hand, if the buy-in payment is too low, then the foreign subsidiary has effectively benefited from a bargain purchase.

A foreign principal can also access intangible property developed in the United States by licensing the make/sell rights from the related owner of those. If the owner is a U.S. person, royalty payments received are typically taxable in the United States.

II. PAST AND PRESENT LAW

This section discusses certain aspects of past and present law that are relevant and applicable to the case studies presented in this document. In particular, this section discusses transfer pricing for intangible property between related parties, certain inclusions of income under subpart F, entity classification (check-the-box regulations), and the prior treatment of possession corporations under section 936. In some cases, the context in which the law changed is described because it is relevant to the analysis of the cases studied.

A. Pricing for Transfers of Intangible Property Between Related Persons

Within a group of related entities,²⁵ there are often no market pressures that impose market pricing on transactions between the related parties, and goods and services are transferred along the supply chain at self-derived prices. Absent transfer pricing rules, the lack of external market forces would permit multinational groups to shift income in any manner they choose among group members. Thus, the United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to a related foreign company through aggressive transfer pricing that does not reflect an arm's-length result. Similarly, the domestic laws of most U.S. trading partners include rules on transfer pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. In 1986, Congress added an additional test for transactions resulting in the transfer of intangible property, which provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property. Section 367(d) provides a related rule under which compensation, in the form of an imputed royalty stream, is required for an outbound transfer of intangible property in the context of an otherwise nontaxable reorganization transaction.

Commensurate with income principle

As discussed above, Congress responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property – including, in particular, high-profit-potential intangibles – by amending section 482 in 1986 and adding the commensurate-with-income principle.²⁶ The legislative history to this provision states that transfer pricing problems

²⁵ The term “related” as used herein refers to relationships described in section 482, which applies to “two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests.”

²⁶ H. R. Rep. No. 99-426, 423.

are “particularly acute” in the case of high-profit-potential intangibles.²⁷ The House Committee on Ways and Means Report (the “Committee Report”) identified, as a recurrent problem, the absence of comparable arm’s-length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm’s-length concept in the absence of real comparables.²⁸ The Committee Report concluded that, because of the “extreme difficulties” in determining whether arm’s-length transfers between unrelated parties are comparable, it was appropriate to require payments made on a transfer of an intangible to a foreign affiliate to be commensurate with the income attributable to the intangible.²⁹

The commensurate with income principle was intended to address these problems by shifting the focus of transfer pricing analysis to the income actually derived from exploitation of the transferred intangible, and away from the identification of questionably comparable third-party transactions. In particular, Congress intended that compensation for intangibles be determined by taking into account actual profit experience, and that pricing adjustments be made upon major variations in the annual amounts of revenue. While the legislative history to the 1986 Act did not address the relationship between the commensurate with income principle and the arm’s-length standard, some commentators interpreted the principle as an “ex post” rule (i.e., actual profits would be used as the basis for re-determining the transfer price retroactively) which conflicted with the arm’s-length standard.³⁰

The Conference Report for the 1986 Act also directed the Internal Revenue Service (the “IRS”) to conduct a comprehensive study of the transfer pricing rules. Treasury and the IRS published the findings of this study in a notice commonly referred to as the White Paper.³¹ An important consequence of this conclusion, reflected in subsequently issued Treasury regulations, was that comparable third-party transactions would continue to play a role in determining

²⁷ *Ibid.*, 424.

²⁸ *Ibid.*, 423-424.

²⁹ *Ibid.*, 425.

³⁰ See e.g. Marc M. Levy and Stanley C. Ruchelman, “Section 482 -- The Super Royalty Provisions Adopt the Commensurate Standard,” 41 *Tax Lawyer* 611 (Spring 1988) (Rather than looking to the bona fides of the transfer at the time of the transfer, Congress intends that, notwithstanding such bona fides, payments must reflect the actual profit experience realized as a consequence of the transfer. Reliance on reasonably calculated, projected profit experience is insufficient. Further, a payment set at the time of transfer and measured as a percentage of sales is insufficient. Thus, taxpayers must initially justify the reasonableness of an intercompany transfer pricing agreement under the facts and circumstances existing at the time entered and must subsequently justify any adjusting payments that reflect the actual profit experience realized as a consequence of the transfer. In essence, a “floating” payment rate that can be adjusted upward to reflect greater than anticipated profit experience is the new measure. (citations omitted)); see also E.C. Lashbrooke, Jr., “I.R.C. §482 Commensurate with Income Standard for Transfers of Intangibles,” 1 *DePaul Bus. L. J.* 173, 186 (1989) (The Congressional mandate that adjustments be made to allocations of income to reflect actual profit experience clearly is a rejection of the holding in *R.T. French v. Commissioner* and similar cases that the determination of a section 482 allocation be based solely on the facts and circumstances in existence at the time of transfer.)

³¹ H.R. Conf. Rep. No. 99-841, pt. 2 (hereafter “Conference Report 99-841”), II-638, and Notice 88-123, 1988-2 C.B. 458 (hereafter, the “White Paper”).

appropriate transfer prices, at least in the case of “normal intangibles.”³² Normal intangibles were described as intangibles that are widely available to producers (such as the technology employed in pocket calculators, digital watches or microwaves) and for which “exact” comparables are more common. The White Paper concludes that in the case of high-value intangibles, transactions between unrelated parties involving comparable intangibles “almost never exist.”³³

The White Paper characterizes the commensurate with income principle as a clarification of prior law that it is consistent with the arm’s-length standard.³⁴ In addition, the IRS applies the commensurate with income principle on an “ex ante” basis, meaning that actual profits are taken into account for purposes of determining if the initial transfer price was appropriate. Thus, the IRS view is that commensurate with the income attributable to the intangible “refers generally to the operating profits that the taxpayer would reasonably and conscientiously have projected at the time it entered into the controlled transaction.”³⁵

Methods of transferring intangible property

A U.S. person that develops or purchases intangible property generally can make that intangible property available to a related person (typically, a foreign affiliate) in one of four ways. The first is through an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a capital contribution of the intangible property to the affiliate in an exchange that meets the requirements of section 351, or an exchange made pursuant to a plan of reorganization that is described in section 361). The second is through a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate.³⁶ The third is the provision of a service using the intangible property, rather than a direct transfer of the property.

³² *Ibid.*, 473.

³³ *Ibid.* However, the *White Paper* states that in the rare instance in which there is a true comparable for a high-profit intangible, the transfer price must be set on the basis of the comparable, because that remains the best measure of how third parties would allocate intangible income.

³⁴ *Ibid.*, 472. The *White Paper* bases this conclusion on a statement in Conference Report 99-841 that income from a transferred intangible should be divided based on the relative economic contributions of the parties. The *White Paper* states that this approach is consistent with what unrelated parties do and concludes from this that the general goal of the commensurate with income requirement is “to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm’s length transfer of the intangible.”

³⁵ AM-2007-07, issued on March 23, 2007, 3, 12. The Advisory Memorandum states that concerns were expressed in both the legislative history and in the White Paper regarding the ability of the IRS to examine, after the fact, taxpayers’ expectations regarding potential profits. The Advisory Memorandum concludes that the intention of the commensurate with income requirement is to give the IRS a presumptive basis for making periodic adjustments, which taxpayers could then rebut, for example by showing that the actual results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time of the transaction.

³⁶ The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer’s conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

In the fourth, intangible property is made available through a cost sharing arrangement. In a typical cost sharing arrangement, a U.S. company and one or more foreign affiliates make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable asset. The U.S. company makes available all, or a substantial portion, of the rights to use and further develop existing intangible property, and the foreign affiliate (typically organized in low-tax jurisdiction) generally contributes cash. The arrangement provides that the U.S. company owns legal title to, and all U.S. marketing and production rights in, the developed property, and that the other party (or parties) owns rights to all marketing and production for the rest of the world.³⁷ Reflecting the split economic ownership of the newly developed asset, no royalties are paid between cost sharing participants when the product is ultimately marketed and sold to customers. However, the U.S. company receives a buy-in payment³⁸ (such as periodic intercompany royalties or a lump sum payment at the outset) from the other cost sharing participant with respect to its “platform” contribution.³⁹

The mechanism used for transferring intangible property to a foreign affiliate frequently dictates whether the authority for determining the compensation received by the U.S. person in the transaction is under section 482 or section 367(d). Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, is subject to section 482. An exchange of intangible property in connection with certain nonrecognition transactions is subject to section 367(d), which overrides the general nonrecognition rules of sections 351 and 361 to require that the transferor of intangible property include imputed income from annual payments over the useful life of the intangible, as though the transferor had sold the intangible (at whatever stage of development it is, from an entirely undeveloped idea through, and including, a completely developed and exploitable item of intangible property), at times in exchange for

³⁷ There are numerous variations on this basic description of a typical cost sharing arrangement. For example, another approach may allocate cost sharing (and, therefore, the profit entitlement thereto) by product or by region (e.g., the U.S. cost sharing participant may be allocated North America, while the foreign cost sharing participant is allocated the rest of the world, or the U.S. cost sharing participant is allocated products A, B and C, while the foreign cost sharing participant is allocated products X, Y, and Z). In addition, any participant in a cost sharing arrangement may contribute its existing intangible property to a cost sharing arrangement (e.g., a foreign subsidiary owns the rights to product X; the foreign subsidiary and its U.S. parent may cost share the next generation of product X).

³⁸ Present regulations refer to “buy-in payments” as “PCT payments,” (i.e., payments for platform contribution transactions). Temp. Treas. Reg. sec. 1.482-7T(b)(ii). The more common term, “buy-in payment,” is used herein. The buy-in payment eliminates the benefit of expense deductions for R&D previously performed in the United States; amounts received in excess of previously deducted R&D expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost sharing payments offset any deductions that the recipient of such payment takes for post-buy-in R&D activities. Such ongoing cost sharing does not, however, include compensation for the expected premium return on any products that may result from that R&D.

³⁹ In this context, a “platform contribution” is any resource, capability, or right that the U.S. company has developed, maintained or acquired outside of the cost sharing arrangement, that is reasonably anticipated to contribute to the development of cost-shared intangibles. Temp. Treas. Reg. sec. 1.482-7T(c)(1). Implicit in the definition of a platform intangible is that resource, capability, or right is made available through the cost-sharing arrangement.

contingent payments. The appropriate amounts of those imputed payments are determined under section 482 and the regulations thereunder. Transfers of foreign goodwill or going concern value are specifically exempt from the income recognition provisions of section 367(d).⁴⁰ With respect to cost sharing arrangements, specified rights to existing intangibles can be transferred to other cost sharing participants either through a sale or a license.⁴¹

Section 482 regulations

In general

A transaction between related parties meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if unrelated taxpayers had engaged in the same transaction under the same circumstances.⁴² Because identical transactions between unrelated parties are rare, whether a transaction produces an arm's-length result generally is determined by reference to the results of transactions deemed to be comparable under circumstances deemed to be comparable.⁴³ To evaluate comparability, the regulations require an analysis of all factors that could affect prices or profits in uncontrolled transactions. Each method requires an analysis of all the factors that affect comparability under that method, and a specific comparability factor may be particularly important to a particular method.⁴⁴ The comparability factors include: (1) functions; (2) contractual terms; (3) risks; (4) economic conditions; and (5) the property or services transferred.⁴⁵

Transfer pricing rules do not require that a comparable transaction be identical to the related party transaction, but it must be sufficiently similar to the related-party transaction to provide a reasonable starting point for determining the arm's-length price.⁴⁶ If there are material differences between the related-party transaction and the comparable transaction, adjustments are made to the relevant formulas, but only if it is possible to determine the impact of those differences on prices or profits with sufficient accuracy.⁴⁷ If it is not possible to determine the impact of those differences on prices or profits with sufficient accuracy, the comparable

⁴⁰ Temp. Treas. Reg. sec. 1.367(d)-1T(b).

⁴¹ A taxpayer might choose a fixed lump sum form of payment if it has net operating losses in the United States that would offset the income from the transfer of the intangible property. In the absence of net operating losses, taxpayers might choose a contingent form of periodic payments.

⁴² Treas. Reg. sec. 1.482-1(b)(1).

⁴³ *Ibid.*

⁴⁴ Treas. Reg. sec. 1.482-1(d)(1).

⁴⁵ *Ibid.*

⁴⁶ Treas. Reg. sec. 1.482-1(d)(2).

⁴⁷ *Ibid.*

transaction may be taken into account in establishing the arm's-length price, but it is considered a less-reliable measure of an arm's-length result.

In many cases, risk can be assigned by contract within an affiliated group to entities with the objective ability to bear such risk. However, whether the risks in the related party transaction and in the comparable transaction are, in fact, comparable may be difficult to ascertain. Nonetheless, the respect given to contractual agreements between related companies is derived from the longstanding doctrine of *Moline Properties v. Commissioner*,⁴⁸ in which the Supreme Court rejected the taxpayer's attempt to disregard the corporate form.⁴⁹ Under the doctrine of corporate entity articulated in *Moline Properties*, the corporation remains a separate taxable entity.⁵⁰

Transfers of intangible property

Treasury regulations issued in 1994 sets forth the basic rules for determining income in connection with a transfer of intangible property.⁵¹ These regulations generally provide that the arm's length consideration for the transfer of an intangible in a controlled transaction (i.e., a transaction between related entities) must be commensurate with the income attributable to the intangible, and it requires taxpayers to apply one of four methods to meet this requirement.⁵²

Comparable uncontrolled transaction method

The first of these is the comparable uncontrolled transaction method, which evaluates the amount charged for an intangible in a controlled transaction by reference to the amount charged in a comparable uncontrolled transaction (i.e., a transaction between unrelated parties).⁵³ The regulations provide that if an uncontrolled transaction involves the transfer of the *same* intangible under the same, or substantially the same, circumstances as the controlled transaction (i.e., an exact comparable), the comparable uncontrolled transaction method generally is the most direct and reliable measure of the arm's length result for a controlled transaction.⁵⁴ Exact

⁴⁸ 319 U.S. 436 (1943).

⁴⁹ Although *Moline Properties* involved an individual shareholder, this rule applies equally to a corporation and its subsidiaries. *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 433 (1949).

⁵⁰ *Moline Properties v. Commissioner*, 319 U.S. 436, 439 (1943).

⁵¹ Treas. Reg. sec. 1.482-4.

⁵² The regulation also permits the use of other unspecified methods, which must take into account the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. Treas. Reg. sec. 1.482-4(d)(1). A taxpayer must apply any method, whether specified or unspecified, in accordance with the overall requirements of Treas. Reg. sec. 1.482-1, including its best method, comparability analysis and arm's length range rules.

⁵³ Treas. Reg. sec. 1.482-4(c)(1).

⁵⁴ Treas. Reg. sec. 1.482-4(c)(2)(ii). Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.

comparables are rare, however, in the case of high-value intangibles. If an exact comparable uncontrolled transaction cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances (i.e., inexact comparables) may be used to apply the comparable uncontrolled transaction method, but the reliability of the method will be reduced. The regulations require that a taxpayer consider whether the intangible that is the subject of the uncontrolled transaction has “similar profit potential” to the taxpayer’s intangible in determining whether the uncontrolled transaction is comparable.⁵⁵ However, this method does not otherwise consider or directly reflect the income attributable to the taxpayer’s intangible.

The remaining methods do require an examination of the income actually derived from the transferred intangible. They differ, however, in the extent to which they rely on comparable uncontrolled transactions.

Comparable profits method

The comparable profits method evaluates the amount charged in a controlled transaction by comparing the operating profit of the “tested party” (generally, the licensee) to the operating profits of uncontrolled taxpayers that engage in similar business activities under similar circumstances. For example, where a U.S. parent company licenses an intangible to a foreign manufacturing subsidiary, the royalty payable by the subsidiary to the parent is evaluated under this method by comparing the operating profit of the subsidiary to the operating profits of comparable uncontrolled manufacturers. If the subsidiary’s profit level differs meaningfully from the profit levels of the uncontrolled manufacturers, the royalty rate paid by the subsidiary is adjusted as necessary to bring the profit level within an acceptable range of those levels. In effect, this method limits the extent to which income from the intangible can be retained by the licensee to the amount that an uncontrolled licensee would be permitted to retain; the remainder of that income is required to be paid to the licensor through the royalty.⁵⁶

Profit split methods

The regulations also provide two profit split methods, under which the relative values of each controlled party’s contribution to the combined profit from use of the intangible are used to determine an arm’s length “profit split.” The arm’s length charge for the intangible is the amount required to achieve the appropriate split of the combined profits.

Comparable profit split method

The comparable profit split method relies exclusively on external market data to determine the appropriate profit split; thus, the combined operating profits of controlled

⁵⁵ Treas. Reg. sec. 1.482-4(c)(2)(iii)(B)(1)(ii).

⁵⁶ Treas. Reg. sec. 1.482-5, including *Example (4)*.

taxpayers are split based on the split of combined operating profits of uncontrolled taxpayers with similar transactions and activities in the relevant business activity.⁵⁷

Residual profit split method

The residual profit split method relies on external transactions principally in order to determine the amount appropriately allocable to routine contributions and, in some cases, to determine the split of residual nonroutine return amongst the parties.⁵⁸ Under this method, income is first allocated to the routine contributions of the controlled parties (including contributions of routine intangibles) based on market returns, and the residual income is then allocated based on the relative value of each party's contribution of nonroutine property.

Periodic adjustments

Periodic adjustments may be required to comply with the commensurate-with-income requirement.⁵⁹ When an intangible is transferred in an arrangement that covers more than one year, the consideration charged for each taxable year may be adjusted by the IRS (in the context of an examination of that year) to ensure that it is commensurate with the income from the intangible. No adjustment will be required if the taxpayer satisfies various requirements, including that the profits earned (or cost savings) realized by the related taxpayer from the exploitation of the intangible is not less than 80 percent, nor more than 120 percent, of the projected profits (or cost savings) when the related party arrangement was established.

2008 temporary regulations on cost sharing arrangements

General principles

The present rules governing cost sharing arrangements are provided in temporary Treasury regulations issued in December, 2008 (the "2008 regulations").⁶⁰ The regulations provide detailed rules for evaluating the compensation derived by each party for its contribution to the arrangement. The 2008 regulations adopt, as a general principle, the "investor model," first introduced in the 2005 proposed regulations, under which each participant is generally expected to earn a return on its aggregate investment of cash, attributable to both its ongoing share of the intangible development costs and its platform and operating cost contributions⁶¹ for purposes of achieving an anticipated return determined on the basis of an appropriate discount

⁵⁷ Treas. Reg. 1.482-6.

⁵⁸ "Routine" contributions (including routine intangibles) are generally contributions for which it is possible to identify market returns. Treas. Reg. sec. 1.482-6(c)(3)(i)(A).

⁵⁹ Treas. Reg. sec. 1.482-4(f)(2).

⁶⁰ Temp. Treas. Reg. sec. 1.482-7T. The 2008 regulations were preceded by proposed regulations in 2005 (the "2005 regulations"), which was the first formal articulation of the investor model. REG-144615-02, 2005-2 C.B. 625.

⁶¹ Temp. Treas. Reg. sec. 1.482-7T(j)(1)(i).

rate that takes into account the risk of the intangible development activity.⁶² The 2008 regulations also adopt, as a general principle, the best realistic alternative principle.⁶³ Under this rule, the total anticipated present value of a cost sharing participant's income attributable to its participation, as of the date of becoming a participant (the cost-sharing investment) is compared to the total anticipated present value of its income that could be achieved from a realistic alternative arrangement (the alternative investment). The realistic alternatives principle states that an unrelated taxpayer would not enter into a cost sharing arrangement unless the anticipated value of entering into the cost-sharing arrangement is at least as great as the anticipated value of the alternative arrangement realistically available to the related party, taking into account differences in risk.

Methods

The 2008 regulations provide five methods for valuing buy-in payments, within the context of the investor model: (1) the comparable uncontrolled price method, which references a comparable cost sharing arrangement with an uncontrolled party;⁶⁴ (2) the income method, which examines the present value of the projected income from the contributing participant's best realistic alternative;⁶⁵ (3) the acquisition price method, which references the acquisition price of a contributed intangible that was recently acquired in an arm's length transaction;⁶⁶ (4) the market capitalization method, which references the parent company's stock market capitalization, increased for its liabilities as of the buy-in date and reduced for the value of tangible property and non-covered intangibles;⁶⁷ and (5) the residual profit split method, which applies only where more than one participant makes significant, nonroutine contributions.⁶⁸ In

⁶² Temp. Treas. Reg. sec. 1.482-7T(g)(2)(ii).

⁶³ Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iii).

⁶⁴ Temp. Treas. Reg. sec. 1.482-7T(g)(3).

⁶⁵ Temp. Treas. Reg. sec. 1.482-7T(g)(4). The projected income from the best realistic alternative is determined using either a comparable uncontrolled transaction method that projects the royalties the contributing participant would have demanded if it had developed the future intangible on its own and licensed that future version, or a comparable profits method. On September 27, 2007, the IRS issued a Coordinated Issue Paper which stated that the income method is generally the best method for valuing initial buy-in payments. "Coordinated Issue Paper Addresses Cost Sharing Arrangement Buy-In Adjustments," Section III.B., LMSB-0400907-62 (Sept. 27, 2007), available at <http://www.irs.gov/businesses/article/0,,id=174320,00.html>.

⁶⁶ Temp. Treas. Reg. sec. 1.482-7T(g)(5). The acquisition price of the intangible is derived from the price paid for the stock or assets of a target that owned the intangible.

⁶⁷ Temp. Treas. Reg. sec. 1.482-7T(g)(6).

⁶⁸ Temp. Treas. Reg. sec. 1.482-7T(g)(7). Under the residual profit split method, the residual divisional operating profit or loss of each participant (after allocations of market returns to routine contributions, operating cost contributions and intangible development cost contributions) is allocated based on the relative value of its non-routine contribution, determined by reference to external benchmarks or the capitalized cost of development.

addition, use of an unspecified method if authorized if its use produces a more reliable arm's-length result.⁶⁹

Intangible development costs

Subject to certain exclusions, intangible development costs generally include all costs, whether in cash or in kind, directly identified with, or reasonably allocable to, the intangible development activity.⁷⁰ Stock option expenses are specifically defined as intangible development costs.⁷¹ The intangible development activity is the activity under the cost sharing arrangement of developing or attempting to develop reasonably anticipated cost shared intangibles.⁷²

Changes in participation

A change in participation requires arm's length compensation from the transferee to the transferor.⁷³ A change in participation can result from either a transfer of interests or a capability variation.⁷⁴ A change in capability variation, which occurs only when interests in a cost sharing arrangement are divided on a basis other than territorial⁷⁵ or field of use,⁷⁶ results when there is a material alteration in the division of interests or the relative capabilities or capacities of the cost-sharing participants.⁷⁷ A change in participation is treated as a transfer of the cost-shared intangible, therefore it is subject to compensation as a platform contribution.⁷⁸

⁶⁹ Temp. Treas. Reg. sec. 1.482-7T(g)(8).

⁷⁰ Temp. Treas. Reg. sec. 1.482-7T(d)(1)(iii).

⁷¹ *Ibid.*; see also Temp. Treas. Reg. sec. 1.482-7T(d)(3) for additional guidance on stock-based compensation.

⁷² Temp. Treas. Reg. sec. 1.482-7T(d)(1)(i).

⁷³ Temp. Treas. Reg. sec. 1.482-7T(a)(3)(iii), (f)(1), (f)(4).

⁷⁴ Temp. Treas. Reg. sec. 1.482-7T(f)(1).

⁷⁵ See Temp. Treas. Reg. sec. 1.482-7T(b)(4)(ii) for additional guidance on territorial based divisional interests.

⁷⁶ See Temp. Treas. Reg. sec. 1.482-7T(b)(4)(iii) for additional guidance on field of use divisional interests.

⁷⁷ Temp. Treas. Reg. sec. 1.482-7T(f)(3).

⁷⁸ *Ibid.*; see also Temp. Treas. Reg. sec. 1.482-7T(a)(3) for additional guidance on stock-based compensation.

Periodic adjustments

The 2008 regulations generally permit the IRS to make periodic adjustments to buy-in payments if the IRS determines that the payor's "actually experienced return ratio" is outside a specified "periodic return ratio range." The regulations provide a number of exceptions, however, under which no adjustment is required. For example, where failure to fall within the periodic return ratio range is due to extraordinary events beyond the participants' control that could not be reasonably anticipated at the time of the buy-in, or where the actually experienced return ratio would fall within the periodic return ratio range if the actually experienced return ratio were recomputed with certain specified adjustments (such as adjustments to reflect delayed exploitation of the intangible), no adjustment is required. In addition, no adjustment is required where the same platform contribution is made to an uncontrolled party on substantially similar terms as the controlled transaction, and the requirements of the comparable uncontrolled transaction method are satisfied.⁷⁹ The rules establish a presumption that the weighted average cost of capital is an appropriate discount rate for applying the periodic adjustment rule to publicly traded companies and their subsidiaries.⁸⁰

Transition rules

A pre-effective date cost-sharing arrangements (an "existing cost-sharing arrangement") is generally subject to the 2008 regulations. An existing cost-sharing arrangement qualifies as a cost-sharing arrangement under the 2008 regulations, provided certain transition rules were completed during 2009.⁸¹ Specific exceptions to the 2008 regulations apply to an existing cost-sharing arrangement qualified as a cost-sharing arrangement (a "qualified arrangement"). These include exceptions to the periodic adjustment rule⁸² and the division of interest rule.⁸³ In general, any platform contribution made to a qualified arrangement is subject to the periodic adjustment rules that generally apply to intangible property.⁸⁴ However, if there is a material change in the scope of a qualified arrangement, any subsequent platform contribution made to a qualified arrangement is subject to the periodic adjustment rules of the 2008 regulations, and does not qualify for the special rules provided in the transition rule.⁸⁵

⁷⁹ Temp. Treas. Reg. sec. 1.482-7T(i)(6)(vi)(A).

⁸⁰ Temp. Treas. Reg. sec. 1.482-7T(i)(6)(iv)(B).

⁸¹ Temp. Treas. Reg. sec. 1.482-7T(m)(1).

⁸² Temp. Treas. Reg. sec. 1.482-7T(m)(2)(ii). An existing cost-sharing arrangement qualified as a cost-sharing arrangement is subject to the periodic adjustment rules of Treas. Reg. sec. 1.482-(f)(2).

⁸³ Temp. Treas. Reg. sec. 1.482-7T(m)(2)(iii).

⁸⁴ See Treas. Reg. sec. 1.482-(f)(2) for this rule.

⁸⁵ Temp. Treas. Reg. sec. 1.482-7T(m)(3).

Nonqualified arrangements

An existing cost-sharing arrangement that does not qualify as a cost-sharing arrangement under the 2008 regulations is generally governed by section 482. In addition, the 2008 regulations provide the IRS limited authority to impute a qualified arrangement where there is a nonqualified arrangement.⁸⁶

Application of section 482 principles to unidentified intangibles

Both sections 367(d) and 482 incorporate by reference the definition of intangible property in section 936(h)(3)(B). Because they are not specifically mentioned in section 936(h), whether goodwill, going concern value and workforce in place are intangible property for which compensation must be provided is unsettled. The IRS has taken the position that any workforce in place, goodwill and going concern value are within the scope of intangible property under section 936(h)(3)(B), because they constitute “similar items” under section 936(h)(3)(B)(vi).⁸⁷

A definition of workforce in place is set forth in the regulations under section 197, which define it as a separate asset that includes “the composition of a workforce (e.g., the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes.”⁸⁸ Prior to the promulgation of these regulations,⁸⁹ the Fourth Circuit, reversing the U.S. Tax Court, held that workforce in place did not have an ascertainable life, but rejected the Tax Court categorical assertion that such an asset “is not separate and distinct from going concern value” because it is not a wasting asset.⁹⁰ The 2008 regulations treat workforce in place as separately compensable if the U.S. parent’s workforce in place is reasonably expected to contribute to the

⁸⁶ Temp. Treas. Reg. sec. 1.482-7T(i)(5).

⁸⁷ See Treas. Reg. sec. 1.482-4(b)(6), which states that “an item is considered similar to those listed ... if it derives its value not from its physical attributes but from its intellectual content or other intangible properties. TAM 200907024 provides the most elaborate description of the IRS position under section 367(d)...Numerous additional matters raising the same issue - the definition of intangible property and the treatment of goodwill - are currently under active audit.”

⁸⁸ Treas. Reg. sec. 1.197-2(b)(3).

⁸⁹ Section 197 was enacted on August 10, 1993, Pub. L. No. 103-66. Treas. Reg. sec. 1.197-2(b)(3) was issued on Jan. 20, 2008. T.D. 8865, 2000-1 C.B. 589.

⁹⁰ *Ithaca Industries v. Commissioner*, 97 T.C. 253, pp. 271-272 (1991), 17 F.3d 684 (4th Cir. 1994), cert. denied, 513 U.S. 821 (1994). However, between the issuance of the Tax Court decision in *Ithaca Industries* and that of the Court of Appeals, the U.S. Supreme Court decided *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993). While the Court of Appeals in *Ithaca Indus.* affirmed the decision of the Tax Court, its reasoning differed from the court below. The Court of Appeals, following the decision in *Newark Morning Ledger*, noted that although it is no longer appropriate to deny a deduction on the basis of the resemblance of an intangible to the classic conception of goodwill or going-concern value, the Supreme Court did not “wholly eliminate a categorical approach to the question” because it had left the mass asset rule intact. 17 F.3d 684, 687 (4th Cir. 1994). See also *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677, p. 690 (1971) (workforce in place “formed a part of the going-concern value which was purchased”).

development of cost-shared intangibles; in this situation, the workforce in place is considered a platform contribution for which the foreign subsidiary must compensate the U.S. parent.⁹¹

The Treasury regulations under section 482 provide that multiple transactions may be considered in the aggregate if doing so provides the most reliable means of determining the arm's length consideration for the controlled transaction.⁹² In determining whether valuation in aggregate or asset-by-asset is the more reliable method, the IRS considers the extent to which the intangibles, both identified and unidentified, are interrelated. This principle of reliability as articulated in section 482 regulations is applied to valuation of outbound intangible transfers under section 367(d).⁹³

Section 6662(e) penalties and documentation

A penalty for understatements of tax attributable to a transfer-pricing issue applies, unless the taxpayer maintains and provides to the IRS upon request contemporaneous documentation supporting the taxpayer's pricing methodology. Even if a taxpayer's understatement does not meet the threshold for application of the transfer-pricing penalty, the understatements may nonetheless be subject to the accuracy-related penalty on one of the other grounds enumerated in section 6662(b).

Under the general rules of section 6662, a penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or \$10,000 if greater) or (b) \$10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. The section 6662 penalty is increased to 40 percent in the case of gross

⁹¹ Temp. Treas. Reg. sec. 1.482-7T(g)(2)(vii)(B), *Example 1*, part (ii). A platform contribution is "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the [cost sharing arrangement]) that is reasonably anticipated to contribute to developing cost shared intangibles..." Temp. Treas. Reg. sec. 1.482-7T(c)(1).

⁹² Treas. Reg. sec. 1.482-1(f)(2)(i), in conjunction with the best method rule of Treas. Reg. sec. 1.482-1(c)(1). Even if aggregation were not expressly provided by the regulations, arguably it would still be implicit in Treas. Reg. sec. 1.482-1(c)(1), which requires taxpayers to use not only the best method, but also the application of a particular method (assuming that there is more than one possible application) that provides the most reliable result.

⁹³ TAM 200907024, p. 14, in which the taxpayer contended that separate contracts between the taxpayer and a large number of foreign agents in numerous countries must be valued separately for purposes of applying section 367(d), and attributed the residual value of the businesses to non-compensable foreign goodwill or going concern value. The IRS rejected this position, stating that it was "more reliable to determine the arm's length consideration for that transfer of a [network of] contracts by considering the separate contracts 'as a whole' because they are 'so interrelated.'" A similar issue is presented in a petition filed with the Tax Court by First Data Corporation, challenging an adjustment by the IRS on this issue. *First Data Corp. v. Commissioner*, No. 007042-09 (T.C. filed Mar. 20, 2009).

valuation misstatements as defined in section 6662(h). In most cases, a penalty may be avoided if a taxpayer establishes that he had reasonable cause and acted in good faith.

In contrast, if the threshold for applicability of the transfer pricing penalty is met, then reasonable cause sufficient to avoid a transfer pricing penalty requires compliance with the contemporaneous documentation requirements. The threshold may be met in one of two ways:

1. The price for any property or services (or for the use of property) claimed on a tax return is 200 percent or more (or 50 percent or less) than the correct price (referred to as a “transactional penalty”) or
2. The net section 482 adjustment for the taxable year exceeds the lesser of (a) \$5 million, or (b) 10 percent of the taxpayer’s gross receipts (referred to as a “net adjustment penalty”).

There are two principal exceptions pursuant to which a taxpayer may avoid a penalty. Both require contemporaneous documentation be maintained and provided to the IRS within 30 days of a request and apply to both the transactional and the net adjustment penalties. Under the first exception, if the taxpayer uses a specified method, the taxpayer must show that the method chosen was reasonable. Under the second exception, if a taxpayer uses an unspecified method, the taxpayer must establish that (a) none of the specified methods was likely to clearly reflect income, and (b) the pricing method used by the taxpayer was likely to produce a price that would clearly reflect income.

With respect to the transactional penalty, the exceptions apply on a transaction-by-transaction basis. Exceptions to the net adjustment penalty operate by excluding from the net section 482 adjustment the portion of the adjustment that satisfies one of the exceptions. If a single transaction is part of a net section 482 adjustment, then the rules for the net adjustment penalty apply to that transaction. For purposes of both exceptions, the regulations provide a non-exclusive list of specific factors to be considered in determining whether the taxpayer’s selection of its method was reasonable.

The regulations identify principal documents that must be maintained, regardless of the type of method used by the taxpayer. The documents must be adequate to accurately and completely describe the analysis conducted by the taxpayer. In addition, background documents must also be available, although need not be provided within 30 days in response to a request for principal documents, but may be subject of a subsequent request within the discretion of the IRS.

Transfer pricing controversies

The appropriate treatment of intangible transfers has consistently been at the center of transfer-pricing disputes⁹⁴ and is central to the few opinions issued in recent years.⁹⁵ In recent

⁹⁴ See, e.g., *Eli Lilly and Company v. Commissioner of Internal Revenue*, 84 T.C. 996 (1985), aff’d in part, rev’d in part, 856 F. 2d 855 (7th Cir. 1988); *Perkin-Elmer Corp. v. Commissioner*, T.C. Memo 1993-414, rejecting the taxpayer’s use of resale pricing where both tangible and intangible property was transferred by a possessions corporation, and *National Semiconductor Corp. v. Commissioner*, T.C. Memo 1994-195, in which the Tax Court

years, the expansion of the Advance Pricing Agreement (“APA”) program, the expiration of section 936 possessions credits,⁹⁶ and the IRS efforts to address the use of cost-sharing agreements to facilitate transfer of intangibles has determined which issues are most prominent in examinations and litigation. As a result, the most significant judicial opinions issued arose in the context of cost-sharing arrangements, i.e., *Xilinx, Inc. v. Commissioner*,⁹⁷ and *Veritas Software Corp., et al. v. Commissioner*.⁹⁸ The first case dealt with the identification of costs that must be shared in a cost-sharing arrangement. The second addressed whether the payment required as compensation for use of preexisting intangibles made available to controlled affiliates pursuant to such arrangements.⁹⁹

In *Xilinx v. Commissioner*, the issue was how to determine the costs that must be shared by the participants, consistent with the arm’s-length standard, under the regulations in effect for taxable years 1997 through 1999. The Tax Court held that cost-sharing participants need not include in the pool of costs to be shared any amount for the value of stock options granted to the employees of the participants because unrelated parties do not do so. The cost-sharing regulations applicable to the years before the court permitted related parties to enter into qualified cost-sharing arrangements if the agreement provided that the participant’s share of intangible development costs reflects that participant’s share of anticipated benefits. In defining the term “intangible development costs,” the regulation stated that the term means “all of the costs incurred by that participant related to the intangible development area,” and specifically

partially sustained the IRS disallowance of losses claimed by the U.S. company for its U.S. distributor on sales of items imported from its offshore subsidiary. But see, *Merck & Co. v. United States* 24 Cl.Ct., 73 , 91-2 USTC & 50,45 (Cl.Ct. 1991), in which the Court held no adjustment was warranted.

⁹⁵ The transfer pricing dispute at the center of *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner* T.C. Docket No. 5750-04, also depended upon treatment of intangibles, i.e. whether the profits made by GlaxoSmithKline Holdings (Americas), Inc., from sales of patented drugs (primarily Zantac) in the United States were principally derived from the R&D performed in the United Kingdom rather than from U.S. marketing and distribution activities. A settlement was announced September 11, 2006.

⁹⁶ Section 936 exit strategies were designated as a Tier I compliance issue on February 2, 2007. See *Industry Director Directive on Section 936 Exit Strategies*, LMSB Control No.: LMSB-04-0107-002, available at <http://www.irs.gov/businesses/corporations/article/0,,id=167555,00.html>; see also Notice 2005-21, 2005-1 C.B. 727. In a typical post-section 936 conversion, the U.S. taxpayer contributed mature Puerto Rican business operations to a CFC in exchange for shares in the CFC or reincorporated as CFC in a non-taxable reorganization under section 368(a)(1)(F). As the effective date of the repeal of section 936 approached, these operations were transferred offshore in order to replace the section 936 tax credit with deferral benefits under the subpart F rules. The prevalent issue in such cases is the amount of compensation required to be paid by the CFC for the transferred assets under section 367(d).

⁹⁷ 125 T.C. 37 (2005), *aff’d*, No. 06-74246 (9th Cir. Mar. 22, 2010).

⁹⁸ 133 T.C. No. 14 (December 10, 2009).

⁹⁹ Cost sharing buy-in payments were designated as a Tier I compliance issue on April 5, 2007. See *Industry Director Directive #1 on Transfer of Intangibles Offshore/ §482 Cost Sharing Buy-in Payment*, LMSB Control No: LMSB-04-0307-027, available at <http://www.irs.gov/businesses/article/0,,id=169313,00.html>. Designation as a Tier I issue reflects the IRS determination that the issue is of high strategic importance and has a significant impact on one or more industries.

included operating expenses as defined in section 1.482-5(d)(3) of the regulations.¹⁰⁰ The regulations did not address the treatment of stock-based compensation.¹⁰¹ Based on the evidence at trial that unrelated parties dealing at arm's-length do not explicitly account for such costs, the Tax Court rejected the government's position as inconsistent with the application of the arm's length standard described in section 1.482-1(b), and held that stock-based compensation was not a cost that must be shared.

In May 2009, the Ninth Circuit reversed the Tax Court, but did not accept the reasoning of the government.¹⁰² On appeal, the government did not appeal the finding that unrelated parties would not share employee stock option costs in the types of transactions on which the Tax Court based its holding. The government position was that such transactions were not comparable to cost-sharing arrangements, rendering the treatment of stock-based compensation by parties to those transactions irrelevant to application of the arm's-length standard. The government argued that the costs must nevertheless be shared in order to achieve an arm's length result. Rejecting that argument, the appellate panel instead agreed with the lower court conclusion that the requirement of the cost-sharing regulations to share "all of the costs" was inconsistent with the arm's-length standard and could not be reconciled. Because the cost-sharing regulation was the more explicit of the two regulatory provisions, the Ninth Circuit held that it controlled. The Ninth Circuit also agreed with the government that stock-based compensation is a cost, and therefore must be included in the pool of costs to be shared.

In March 2010, the Ninth Circuit affirmed the Tax Court decision, and concluded that the arm's-length standard did not require that stock-based compensation costs of related parties be shared under cost-sharing agreements. In reaching this conclusion, the Ninth Circuit examined what it referred to as the "dominant purpose" of the regulation, which it said was to create "parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions." Thus, it concluded that if Xilinx were required to share its stock option costs, Xilinx would not have had tax parity with an independent taxpayer.

In *Veritas Software Corp., et al. v. Commissioner*, the issue was the adequacy of the lump-sum payment made by a cost-sharing participant for use of the intangibles it made available to the U.S.-Ireland cost-sharing arrangement. The Irish affiliate paid the U.S. party a sum of \$118 million for license to pre-existing intangibles, based on prices charged to third-party licensees. The IRS contested the comparability of the licenses on which the taxpayer based its argument, contending that the scope of each of the various third-party licenses was far narrower than the bundle of rights made available to the cost-sharing arrangement, and that a valuation of the rights transferred could not be reliably computed by adding the prices charged when the various rights were separately transferred to third parties. Instead, the IRS argued that the related

¹⁰⁰ Treas. Reg. sec. 1.482-7A(d)(1), in effect on or before January 4, 2009. Section 1.482-7(d)(1)(ii).

¹⁰¹ Later regulations, finalized in 2003, explicitly required that stock-based compensation be included in costs to be shared under a qualified cost-sharing arrangement in order to satisfy the arm's length standard. See T.D. 9088, 2003-2 C.B. 841. That requirement is continued in the 2008 regulations at Treas. Reg. sec. 1-482-7(a) and (d)(3). Neither the 2003 nor 2008 regulations were at issue in *Xilinx v. Commissioner*.

¹⁰² No. 06-74269, Slip Op. (9th Cir. May 27, 2009), withdrawn January 13, 2010.

party transfer of multiple rights should be valued as an aggregation of rights, in order to properly account for synergies or additional value to the cost-sharing arrangement in having the collective rights, as if a going concern had been transferred. The IRS argument was that the transfer of the existing intangibles, with related attributes and access to the U.S.-based R&D workforce was the economic equivalent of transferring the business. Although initially claiming that the buy-in should have been \$2.5 billion, at trial the IRS argued that the appropriate buy-in payment was \$1.7 billion, based on foregone profits and acquisition pricing methods.

The theory that the cost-sharing arrangement was akin to a sale was rejected. In its holding, the Tax Court found that both the initial deficiency determination and the reduced deficiency on which the IRS presentation at trial was based were arbitrary and capricious. The Tax Court accepted the taxpayer's use of "unbundled" licenses as comparable, uncontrolled transactions that could reliably be used to value the transfer of the bundled rights, and sustained the taxpayer's position, with few adjustments.

The APA Program

An APA is an agreement between a taxpayer and the IRS that determines the acceptable transfer pricing methodology for covered transactions in the years subject to the agreement. The procedures for obtaining an APA were first published in 1991,¹⁰³ and are now found in Rev. Proc 2006-9.¹⁰⁴

The agreements generally specify a transfer pricing method, and provide for a range of results that will be considered arm's length. Thus, provided that the taxpayer uses the specified method and the result is within that arm's-length range, the IRS accepts the results without further inquiry. If the results are not within the range specified in the APA, the APA may permit the IRS to make an income adjustment solely for the purpose of achieving the specified result.¹⁰⁵ In general, the preferred term of an APA is five years.¹⁰⁶ Since 1999, APAs and related background materials have been afforded the same confidentiality protections as tax returns under section 6103.

If the APA is unilateral, the agreement is only between the taxpayer and the IRS. In contrast, a bilateral APA involves an agreement between the taxpayer, the IRS, a foreign affiliate of the taxpayer, and the tax authority of the country in which that foreign affiliate is organized. Bilateral or multilateral agreements typically involve a foreign affiliate organized in a country in which the tax authorities are likely to have an interest comparable to that of the IRS in ensuring that the correct transfer price is paid for finished goods sold from the foreign affiliate to the U.S. company.

¹⁰³ Rev. Proc. 91-22, 1991-1 C.B. 526.

¹⁰⁴ 2006-1 C.B. 278, modified by Rev. Proc. 2008-31, 2008-23 I.R.B. 1133, which added a sentence to section 2.01 to identify additional issues that may be resolved under the APA process.

¹⁰⁵ 2006-1 C.B. 278, 289 – 290.

¹⁰⁶ 2006-1 C.B. 278, 283.

The APA process is voluntary, and has five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement, and (5) drafting, review, and execution. An IRS team headed by an APA team leader is responsible for the consideration of each APA. The team leader is responsible for organizing the IRS APA team. The IRS APA team leader arranges meetings with the taxpayer, secures whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder, and leads the discussions with the taxpayer. The APA team generally includes an economist, an international examiner from the Large and Mid-size Business Division of the IRS¹⁰⁷ ("LMSB"), LMSB field counsel, and, in a bilateral case, a U.S. Competent Authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or the IRS field organization. The APA team may also include an LMSB International Technical Advisor, other LMSB exam personnel, and/or an Appeals Officer.¹⁰⁸

The IRS may revoke an APA due to fraud, malfeasance or disregard by the taxpayer in connection with the APA, whether in the original APA request or subsequent submissions (such as the taxpayers annual report) or the taxpayer's lack of good faith compliance with the APA's terms and conditions. In addition, the APA may be canceled due to the taxpayer's misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA.¹⁰⁹

The Secretary of the Treasury is required to make an annual report to the public on APAs and the APA program.¹¹⁰

¹⁰⁷ LMSB serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million. These businesses employ a large number of employees and deal with complicated issues involving tax law and accounting principles.

¹⁰⁸ Announcement 2010-21, 2010-15 I.R.B. 551.

¹⁰⁹ 2006-1 C.B. 278, 291.

¹¹⁰ Sec. 521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999; annual reports are available at <http://www.irs.gov/businesses/corporations/article/0,id=96191,00.html>.

B. Subpart F

The subpart F rules¹¹¹ limit tax deferral with respect to certain categories of passive or highly mobile income. Under the subpart F rules, a 10-percent or greater U.S. shareholder (each, a “U.S. Shareholder”) of a CFC is subject to U.S. tax currently on its pro-rata share of certain income earned by the CFC,¹¹² whether or not such income is distributed. Income subject to current inclusion under subpart F includes foreign base company income.¹¹³ Foreign base company income includes foreign personal holding company income (including dividends, interest, and royalties), foreign base company sales income and foreign base company services income.¹¹⁴ Additionally, income subject to current inclusion under subpart F also includes a U.S. shareholder’s pro-rata share of the CFC’s earnings to the extent invested by the CFC in U.S. property.¹¹⁵

Foreign personal holding company income

In general

Foreign personal holding company income is one type of subpart F income that is subject to current U.S. tax. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits (“REMICs”); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

There are several exceptions to the general rule of current taxation on foreign personal holding company income. Two exceptions are the “related party same country” exception and the “active royalties” exception.

Under the first exception, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

¹¹¹ Secs. 951-965.

¹¹² Sec. 951(a)(1)(A).

¹¹³ Sec. 952(a).

¹¹⁴ Sec. 954(a).

¹¹⁵ Sec. 951(a)(1)(B) and Sec. 956.

Under the second exception, foreign personal holding company income does not include royalties received by the CFC from unrelated persons in the active conduct of the CFC's trade or business.¹¹⁶ Royalties are considered derived in the active conduct of a trade or business if derived by the CFC (the licensor) from licensing: (1) property that the licensor has developed, created, or produced, or to which the licensor has added substantial value after acquisition, but only so long as the licensor is regularly engaged in the development, creation or production of, or the acquisition and addition, of substantial value to, property of such kind; or (2) property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own staff or employees located in a foreign country, maintains and operates an organization in such country that regularly engages in the business of marketing, or marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.¹¹⁷

CFC look-through rule

In 2006, Congress enacted section 954(c)(6) on a temporary basis.¹¹⁸ Under the CFC look-through rule, dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties, received by one CFC from a related CFC, are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor effectively connected with a U.S. trade or business.

For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person (or persons) that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.¹¹⁹ Although this provision expired December 31, 2009, section 264 of the American Jobs and Closing Tax Loopholes Act (H.R. 4213) which passed the House on May 28, 2010, and is now under consideration in the Senate, extends these provisions for one year.

Foreign base company sales income

Foreign base company sales income consists of income derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured outside the CFC's country of

¹¹⁶ Sec. 954(c)(2)(A). This exception applies to rents received in the active conduct of a trade or business as well.

¹¹⁷ Treas. Reg. sec. 1.954-2(d).

¹¹⁸ Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 103(b)(1) (2006).

¹¹⁹ Sec. 954(d)(3).

incorporation and sold for use outside of that same country for the income from its sale to be considered foreign base company sales income.¹²⁰

Manufacturing exception

The manufacturing exception that is implicit in the statute is expressly stated in Treasury regulations, which provide that foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by the CFC, in whole or in part, from personal property that it has purchased.¹²¹ A CFC can qualify for the manufacturing exception if it meets one of the three tests. The first two are physical manufacturing tests: the substantial transformation test and the substantial activity test. The third test, the substantial contribution test, was added by the 2008 regulations and is discussed in detail below.

Under the substantial transformation test, a CFC is considered to have manufactured a product if it purchases and “substantially transforms” personal property prior to its sale. This requirement involves, for example, the transformation of raw materials into a finished product, such as processing and converting wood pulp into paper or the transformation of steel rods to screws.¹²²

Under the substantial activity test, a CFC is considered to have manufactured a product through the assembly or conversion of component parts, provided the activities are substantial in nature and generally considered to constitute the manufacture, production or construction of property.¹²³ Under this second test, a safe harbor presumes the CFC will have manufactured a product if its conversion costs account for at least 20 percent of the total cost of goods sold (i.e., direct labor and factory burden).¹²⁴ Conversion costs exclude costs for packaging, repackaging, labeling, and minor assembly operations, as these activities are not considered to constitute manufacturing activities.¹²⁵

In *Bausch & Lomb, Inc. v. Commissioner*,¹²⁶ the Tax Court held that sunglass assembly operations performed by two CFCs satisfied the second test (i.e., the substantial activity test). Each CFC had a trained and skilled workforce that engaged in a range of activities necessary to assemble sunglass parts into finished sunglasses. Accepting testimony from an industry expert

¹²⁰ Sec. 954(d)(1).

¹²¹ Treas. Reg. sec. 1.954-3(a)(4).

¹²² Treas. Reg. sec. 1.954-3(a)(4)(ii).

¹²³ Treas. Reg. sec. 1.954-3(a)(4)(iii).

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

¹²⁶ T.C. Memo 1996-57 (1996).

that the sunglass industry would recognize the operations of the CFCs as the manufacturing of “quality sunglasses,” the Court found that the CFCs had manufactured the personal property that they subsequently sold.¹²⁷

Branch rules

Special branch rules may apply in cases in which a CFC carries on purchasing, selling, or manufacturing activities outside its country of organization through a branch or similar establishment (referred to hereafter as a “branch”).¹²⁸ If the branch is treated as a separate corporation under the sales branch rules, purchasing and sales income derived by the branch generally will be foreign base company sales income. Similarly, if there is a manufacturing branch that is treated as a separate corporation, purchasing and sales income derived by the remainder of the CFC and foreign sales branches of the CFC generally will be foreign base company sales income. The branch rules address situations in which income derived by selling activities has been separated from income derived by manufacturing activities for purposes of obtaining a lower tax rate on the sales income.¹²⁹ The rules apply, however, only if the use of the branch has substantially the same tax effect as if it were a separate corporation. Whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined under regulations, and is based on a tax rate disparity test.

Under the sales branch rule, the tax rate disparity test assumes that the manufacturing operation is retained by the CFC and evaluates whether the selling activities have been shifted to a selling branch to obtain a lower tax rate on the selling income.¹³⁰

While section 954(d)(2) expressly provides a branch rule for purchasing or sales activities occurring outside the CFC’s country of organization, it does not expressly provide a manufacturing branch rule, which is provided only in regulations. Under the regulations, if the conduct of manufacturing¹³¹ activities by or through a branch located outside the CFC’s country of organization has the same tax effect as if such branch were a separate corporation, then the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining whether the CFC has foreign base company sales income.¹³² Whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined

¹²⁷ T.C. Memo 1996 -57, 108 (1996); see also *Dave Fischbein Manufacturing Co. v. Commissioner*, 59 T.C. 338 (1972), *acq.* 1973-2 C.B. 2 (multi-faceted assembly that required six hours and 58 steps to complete was substantial in nature and generally considered manufacturing).

¹²⁸ Sec. 954(d)(2); Treas. Reg. sec. 1.954-3(b).

¹²⁹ H.R. Report No. 1447, 87th Congress 2nd Session; H.R. 10650, at par. XIV.B.4; see also Senate Report No. 1881, 87th Congress 2nd Session; H.R. 10650, par. XII.C.3.b.

¹³⁰ Treas. Reg. sec. 1.954-3(b)(1)(i).

¹³¹ As used here, “manufacturing” includes producing, constructing, growing or extracting activities. Treas. Reg. sec. 1.954-3(a)(2).

¹³² Treas. Reg. sec. 1.954-3(b)(1)(ii).

based on a tax rate disparity test. This test assumes that the selling operation is retained by the CFC, and compares the tax rate imposed on the sales income by the CFC's country of organization to the tax rate that would have been charged had the sales income been recognized in the country where the manufacturing branch is located.¹³³

The tax rate disparity tests differ slightly under the two branch rules. Under the sales branch rule, the sales branch is treated as a separate corporation if the effective tax rate on its sales income is less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to that same income if it had been earned in the CFC's country of incorporation (i.e., where the manufacturing income is earned).¹³⁴ Thus, the test looks to whether the tax rate of the branch is too low in comparison to the CFC.

In contrast, under the manufacturing branch rule, the manufacturing branch is treated as a separate corporation if the effective tax rate on the CFC's sales income¹³⁵ is less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to such sales income in the country in which the branch is located.¹³⁶ Thus, the test looks to whether the tax rate of the CFC is too low in comparison to the manufacturing branch.

In each case, several distinct assumptions are made in determining the allocation of income to the branch and to the nonbranch income of the CFC.¹³⁷

Contract manufacturing

Historically, the Code and regulations did not expressly address the application of the foreign base company sales income rules to contract manufacturing arrangements. However, based on IRS rulings, the first of which was Rev. Rul. 75-7,¹³⁸ taxpayers relied on the manufacturing activities of a contract manufacturer, and attributed these activities to the hiring company (in this context, a hiring CFC) – the principal in a contract manufacturing arrangement – for purposes of the manufacturing exception to subpart F.

In Rev. Rul. 75-7, the hiring CFC owned the raw materials, work-in-progress, and finished goods, controlled the timing and quantity of production, as well as the manufacturing process, and had both the risk of loss and the right to profit (after payment of the contract manufacturer's conversion fee) with respect to the commercialization of the finish goods. The IRS ruled that the manufacturing exception was satisfied, but also that the CFC was deemed to

¹³³ Treas. Reg. sec. 1.954-3(b)(1)(ii).

¹³⁴ Treas. Reg. sec. 1.954-3(b)(1)(i)(b).

¹³⁵ This is commonly referred to as the "remainder of the CFC."

¹³⁶ Treas. Reg. sec. 1.954-3(b)(1)(ii)(b).

¹³⁷ See Treas. Reg. sec. 1.954-3(b)(1)(i)(b), (ii)(b).

¹³⁸ 1975-1 C.B. 244.

have a manufacturing branch in the country in which the corporate contract manufacturer was organized. The ruling did not treat this deemed manufacturing branch as a separate corporation from the CFC under Treas. Reg. sec. 1.954-3(b)(1)(ii) because the manufacturing was undertaken in a jurisdiction with a lower tax rate than that of the selling corporation. Thus, there was no tax rate disparity with respect to the deemed manufacturing branch.

In *Ashland Oil Co. v. Commissioner*¹³⁹ and *Vetco, Inc. v. Commissioner*,¹⁴⁰ taxpayers challenged whether the IRS was correct in asserting that a hiring CFC's contract manufacturing arrangement with a corporate contract manufacturer gave rise to a manufacturing branch in the country in which the contract manufacturer was located. The Tax Court held in each case that, it would not deem a corporate contract manufacturer, whether related to the CFC or not, as a branch of the hiring CFC. The effect of these decisions was to position taxpayers to claim the benefit of attribution for purposes of the manufacturing exception, without the imposing constraint of an implied manufacturing branch – and thus the requisite application of the tax rate disparity test – for purposes of the foreign base company sales income rule.

Proscribed by *Ashland* and *Vetco* from deeming a manufacturing branch in situations where the taxpayer relies on attribution, the IRS ultimately issued Rev. Rul. 97-48 and revoked Rev. Rul. 75-7, stating that it would no longer permit attribution of the activities of a contract manufacturer to a CFC for purposes of section 954(d). Commentators widely criticized Rev. Rul. 97-48 as an incorrect application of relevant law,¹⁴¹ and it is generally understood that taxpayers continued to rely on the manufacturing exception based on attribution. Proposed regulations were issued in 1998 that would have required the selling corporation, itself, to perform manufacturing activities for purposes of the manufacturing exception.¹⁴² However, these regulations were withdrawn shortly thereafter.¹⁴³

In addition to attribution, some taxpayers have relied on the so-called “its” argument as a means of qualifying contract manufacturing arrangements under the manufacturing exception. This position relies on the plain language of the statute that foreign base company sales income

¹³⁹ 95 TC 348 (1990).

¹⁴⁰ 95 TC 579 (1990).

¹⁴¹ See e.g., David Noren, “US Tax Treatment of Contract Manufacturing Arrangements: Change Afoot?,” *International Transfer Pricing Journal*, 307, 310 (Sept./Oct., 2007) (“Taxpayers have adopted a range of different contract manufacturing structures and positions based on the existing law and guidance... including reliance on attribution of manufacturing activities from contract manufacturing notwithstanding the IRS position set forth in Rev. Rul. 97-48.”); Kevin Dolan, Carolyn DuPuy, and Patrick Jackman, “Contract Manufacturing: The Next Round,” *27 Tax Management International Journal*, 29 (Feb. 13, 1998); James Fuller, Jennifer Fuller, Ronald Schroetenboer, Kenneth Clark, and William Colgin, “Rev. Rul. 97-48 and the Revocation of Rev. Rul. 75-7,” *15 Tax Notes International*, 1783 (Dec. 1, 1997); Michael DiFronzo and McClintock, “Contract Manufacturing: Still a Viable Strategy?,” *17 Tax Notes International*, 589 (Aug. 24, 1998); Lowell Yoder, “New IRS Rocks the Contract Manufacturing Boat,” *9 Journal of International Taxation*, 6 (Feb., 1998).

¹⁴² REG-104537-97, 1998-1 C.B. 892.

¹⁴³ REG-113909-98, 1999-2 C.B. 125.

includes “the purchase of personal property from a related person and *its* sale to any person” (emphasis added). Thus, a CFC that purchases personal property that is then transformed into a different product before its subsequent sale does not derive foreign base company sales income on the subsequent sale because the manufactured product is not the same – without regard to the activities or contributions of the CFC in the transforming the personal property – as the property originally purchased by the CFC. The so-called “naked its” position refers to a hiring CFC that has no functional substance and which makes little or no contribution towards the manufacturing performed by the contract manufacturer.

2008 regulations

On December 24, 2008, the Treasury Department and IRS issued final, temporary, and proposed regulations concerning the foreign base company sales income rules. The finalized portion of the regulations address contract manufacturing arrangements, while the proposed portion of the regulations (which was also issued in temporary form)¹⁴⁴ modifies the branch rules. The preamble to the regulations rejects the “its” position and states the government’s view that this position “is contrary to existing law, and represents an incorrect reading of section 954(d)(1).”¹⁴⁵ In addition, the regulations do not revoke the IRS’s position on attribution as stated in Rev. Rul. 97-48, but rather expand the definition of manufacturing to include a third category of manufacturing activities, referred to as the nonphysical activities.

These new regulations are generally applicable to taxable years of CFCs beginning after June 30, 2009, and for tax years of U.S. shareholders in which or with which such tax years of the controlled foreign corporations end. However, subject to certain conditions, the taxpayer may choose to apply these rules retroactively with respect to its open tax years.¹⁴⁶

New contract manufacturing rules

Under the new contract manufacturing regulations, the income of a CFC earned as the principal in a contract manufacturing arrangement is not subject to current taxation as subpart F income, provided the CFC makes a substantial contribution, through its own employees, to the manufactured property that it sells. To qualify for the manufacturing exception, the personal property must have undergone a physical manufacturing process. However, it is not necessary for any of the CFC’s direct employees to perform the actual physical manufacturing activities. Rather, the CFC can meet the manufacturing exception by making a substantial contribution through the “nonphysical” manufacturing activities of its employees.

¹⁴⁴ As proposed regulations, these regulations remain open for taxpayer comment. As temporary regulations, these will expire within three years from the date of issue under section 7805(e)(2), meaning that they expire on or before December 23, 2011. Temp. Treas. Reg. sec. 1.954-3T(g).

¹⁴⁵ T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, A.2.c.; see also Treas. Reg. sec. 1.954-3(a)(4) (“A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it is purchased.”).

¹⁴⁶ Treas. Reg. sec. 1.954-3(d).

To meet the substantial contribution test, the specific categories of activities potentially performed by the CFC's employees include: (1) oversight and direction of manufacturing activities or process pursuant to which the property is manufactured, produced, or constructed; (2) performance of activities that are considered in, but that are insufficient to satisfy, the "substantial transformation" or "substantial activities" tests; (3) material selection; (4) vendor selection; (5) control of raw materials, work-in-process, and finished good; (6) management of manufacturing costs or capacities; (7) control of manufacturing related logistics; (8) quality control; and (9) direction of the development, protection, and use of trade secrets, technology, product design, and design specifications, and other intellectual property used in manufacturing the product.¹⁴⁷

Of these categories, there is no single overriding or controlling factor. Instead, it is a facts and circumstances determination that depends on the economic importance of the activity to the manufacture of the product.¹⁴⁸ In addition, the ownership of the raw materials is not relevant in the determination, such that there is no distinction between toll (consignment) and traditional contract manufacturing.¹⁴⁹ In general, the location of the manufacturing activity will be where the CFC makes its contribution through its employees.¹⁵⁰ The CFC cannot satisfy the substantial contribution test on the basis of anyone in an agency relationship with the CFC; rather, its own employees, as that term is defined for U.S. Federal tax purposes, must conduct the relevant activities.¹⁵¹ Similarly, the activities of a person employed by the CFC's DRE are only taken into account if that person is considered an employee of the DRE under the U.S. Federal tax definition of "employee." There are no safe harbor provisions,¹⁵² and both the substantial contribution and branch manufacturing analyses are made on a product-by-product basis.¹⁵³ Furthermore, mere contractual rights, legal title, tax ownership, and assumption of economic risk of loss are not considered when determining whether there is substantial contribution.¹⁵⁴

¹⁴⁷ Treas. Reg. sec. 1.954-3(a)(4)(iv)(b).

¹⁴⁸ Treas. Reg. sec. 1.954-3(a)(4)(iv)(a).

¹⁴⁹ Treas. Reg. sec. 1.954-3(a)(4)(iv)(d), *Example 3*.

¹⁵⁰ Temp. Treas. Reg. sec. 1.954-3T(b)(4)(i)(c)(3)(iv).

¹⁵¹ T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, A.4.

¹⁵² T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, A.3.

¹⁵³ T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, A.5.; see also Treas. Reg. sec. 1.954-3(a)(4)(iv)(d), *Example 11*.

¹⁵⁴ T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, A.2.b.

New branch rules

For purposes of applying the branch rule, the temporary regulations provide guidance for determining the location of manufacturer, and the rules for applying the tax rate disparity test in cases involving multiple manufacturing and sales branches.

The cornerstone of the temporary regulations is that a CFC performing manufacturing activities in multiple locations will be considered as having a single manufacturing location for purposes of applying the tax rate disparity test. If any single location independently satisfies any of the manufacturing tests, that location is treated as the manufacturing location.¹⁵⁵ If there are multiple locations that independently satisfy either of the physical manufacturing tests, or substantial contribution test, the location of manufacturing is the location with the lowest effective tax rate.¹⁵⁶ If there are multiple locations but no single location independently satisfies a manufacturing test, but together they provide a substantial contribution to the manufacture of the product, then the manufacturing location will be deemed to be the location of sale or purchase if a “demonstrably greater” amount of the CFC’s activities contributing to the manufacture of the product occur in jurisdictions with no tax rate disparity (as that term is used in this context) relative to the sale and purchase location than occur in other jurisdictions.¹⁵⁷

Otherwise, the location of manufacture will be deemed to be the location imposing a tax rate that is sufficiently greater than the rate imposed on the sales income, thereby creating a tax rate disparity (as that term is used in this context) relative to the sales and purchases income.¹⁵⁸ In the first case (i.e., the manufacturing location is deemed to be the location of sale or purchase), no foreign base company sales income will result. In the latter case (the location of manufacture is the location with excessive tax rate disparity, as that term is used in this context, relative to the sales and purchase location), foreign base company sales income may result.

For purposes of the branch rule, the location in which activities take place is where the relevant personnel are when they perform such activities, not the location of the employing company.¹⁵⁹

The interaction of the branch rules with the substantial contribution test may subject certain transactions to current taxation under subpart F that had not previously been so taxed. These transactions involve the purchase of personal property from an unrelated person followed by its sale to an unrelated person. Under the new branch rule, a CFC that (1) purchases from, and sells to, unrelated persons, (2) has employees whose activities render a substantial contribution to the manufacture of the personal property outside the country of the CFC’s

¹⁵⁵ Temp. Treas. Reg. sec. 1.954-3T(b)(1)(ii)(c)(3)(ii).

¹⁵⁶ *Ibid.*

¹⁵⁷ Temp. Treas. Reg. sec. 1.954-3T(b)(1)(ii)(c)(3)(iii).

¹⁵⁸ *Ibid.*

¹⁵⁹ Temp. Treas. Reg. sec. 1.954-3T(b)(1)(ii)(c)(3)(iv).

incorporation, is deemed to have a manufacturing branch. In this case, the manufacturing branch must be evaluated under the tax rate disparity test to determine if the CFC has foreign base company sales income.¹⁶⁰

Foreign base company services income

Foreign base company services income consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party (sec. 954(e)). This includes "substantial assistance" contributing to the performance of services by a CFC that has been furnished by a related person or persons.¹⁶¹ Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person or persons to the CFC if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test will be satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.¹⁶²

U.S. property held by CFCs

A U.S. Shareholder that owns stock in a CFC on the last day of the taxable year must include in its gross income the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not previously taxed¹⁶³) (a "section 956 inclusion").¹⁶⁴ The section 956 inclusion for any taxable year is generally the lesser of (1) the excess of such shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year over the amount of previously taxed income from prior section 956 inclusions¹⁶⁵ with respect to such shareholder, or (2) such shareholder's pro rata share of the applicable earnings of such CFC.¹⁶⁶

¹⁶⁰ T.D. 9438, 2009-1 C.B. 387, Preamble, Summary of Comments and Explanation of Provisions, D.5.

¹⁶¹ Treas. Reg. sec. 1.954-4(b)(1)(iv).

¹⁶² Notice 2007-13, 2007-5 IRB 410. Prior to the issuance of the Notice, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which were a principal element in producing the income from the performance of such services by the CFC.

¹⁶³ Sec. 959(a)(2).

¹⁶⁴ Sec. 951(a)(1)(B).

¹⁶⁵ See sec. 959(c)(1)(A).

¹⁶⁶ Sec. 956(a).

The U.S. property held (directly or indirectly) by a CFC must be measured as of the close of each quarter in the taxable year.¹⁶⁷ The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the CFC's earnings and profits, reduced by any liability to which the property is subject.

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and the right to use certain intellectual property in the United States.¹⁶⁸ Specified exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain export property, certain trade or business obligations, stock or debt of certain unrelated U.S. corporations, and certain deposits or receipts of collateral or margin by, and certain repurchase or reverse repurchase agreement transactions entered into by or with, a securities or commodities dealer in the ordinary course of the dealer's business.¹⁶⁹

¹⁶⁷ *Ibid.*

¹⁶⁸ Sec. 956(c)(1).

¹⁶⁹ Sec. 956(c)(2).

C. Entity Classification

In 1997, Treasury and the IRS issued the so-called “check-the-box” regulations,¹⁷⁰ which provide taxpayers an elective method to determine the classification of an eligible entity as either a corporation, partnership, or disregarded as an entity separate from its owner (“DRE”). A DRE is treated in the same manner as a sole proprietorship, in the case of an entity owned by an individual, and in the same manner as a branch or division, in the case of an entity owned by a corporation or partnership.

In general, the check-the-box regulations make classification of an entity (whether domestic or foreign) explicitly elective, subject to minimal restrictions, for entities that are not publicly traded. Certain entities are treated as “per se corporations” for which an election is not permitted.¹⁷¹ Generally, these are domestic entities formed under a State corporate statute, and certain foreign business entities listed in the regulations.¹⁷²

An eligible entity with two or more members may elect to be classified as a corporation or a partnership.¹⁷³ If a domestic eligible entity with two or more members does not make an election, default rules treat the entity as a partnership.¹⁷⁴ If a foreign eligible entity with two or more members does not make an election, default rules treat the entity as either a partnership, if at least one member does not have limited liability,¹⁷⁵ or as a corporation, if all members have limited liability.¹⁷⁶

A single member entity may elect to be treated either as a corporation or as a DRE.¹⁷⁷ An eligible single-member domestic entity may elect to be treated as a corporation, otherwise its default treatment is as a DRE.¹⁷⁸ A single-member foreign entity corporation may elect to be treated as a DRE, otherwise its default treatment is as a corporation, if the single owner has limited liability,¹⁷⁹ and as a DRE if the owner does not have limited liability.¹⁸⁰

¹⁷⁰ Treas. Reg. sec. 301.7701-2, *et seq.*

¹⁷¹ Treas. Reg. sec. 301.7701-3(a).

¹⁷² The list of per se foreign corporations is provided at Treas. Reg. sec. 301.7701-2(b)(8).

¹⁷³ Treas. Reg. sec. 301.7701-3(a).

¹⁷⁴ Treas. Reg. sec. 301.7701-3(b)(1)(i).

¹⁷⁵ Treas. Reg. sec. 301.7701-3(b)(2)(i)(A).

¹⁷⁶ Treas. Reg. sec. 301.7701-3(b)(2)(i)(B).

¹⁷⁷ Treas. Reg. sec. 301.7701-3(a).

¹⁷⁸ Treas. Reg. sec. 301.7701-3(b)(1)(ii).

¹⁷⁹ Treas. Reg. sec. 301.7701-3(b)(2)(i)(B).

Generally, a foreign DRE keeps its own separate books and records as required under the local law of the country in which it is organized. In addition, annual information reporting is required for U.S. tax purposes with respect to each foreign DRE.¹⁸¹

The check-the-box regulations were intended to relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of unincorporated entities, when classification was effectively elective for well-advised taxpayers. The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. Nevertheless, Treasury and the IRS recognized that such increased flexibility in entity classification in the foreign context could provide greater opportunities than under existing regulations for inconsistent, or hybrid, entity classification in which an entity is treated as a taxable entity in one country but as a flow-through entity in another country.

In Notice 98-11, the IRS and Treasury Department announced that they had become aware of the increased use of certain transactions that utilized “hybrid branches” to circumvent the purposes of subpart F. The notice defined a hybrid branch as an entity with a single owner that is treated as a separate entity under the relevant tax laws of a foreign country and as a branch (i.e., DRE) of a CFC that is its sole owner for U.S. tax purposes. In each of the transactions described in the notice, a taxpayer utilized a hybrid branch arrangement to make deductible interest payments that reduced the CFC’s foreign tax liability, and created low-taxed interest income in another entity, without creating subpart F income.

Notice 98-11 describes the subject transactions as inconsistent with one purpose of subpart F, to prevent CFCs from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to generate inappropriately low- or non-taxed income on which U.S. tax might be permanently deferred. Notice 98-11 stated that the IRS and Treasury Department would issue regulations to address such transactions, as well as certain partnership or trust arrangements raising similar issues. When issued, those proposed regulations treated various hybrid branch arrangements were as giving rise to subpart F income.

¹⁸⁰ Treas. Reg. sec. 301.7701-3(b)(2)(i)(C).

¹⁸¹ Form 8858. It has been asserted that a DRE “disappears from the Treasury’s vision.” See e.g. *Rosanne Altshuler and Harry Grubert, “The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies,” 7 Florida Tax Review 153 (2005)* (powerpoint presentation available at [www.bus.umich.edu/OTPR/altshuler percent20grubert percent20milan.ppt](http://www.bus.umich.edu/OTPR/altshuler%20grubert%20milan.ppt)). The tax accounting for a foreign DRE is not similar to the financial accounting for an “off balance sheet” special purpose vehicle, which in some circumstances may not be observable in the financial statements of the company with which it was associated by operation of generally accepted accounting principles. Instead, a foreign DRE maintains the books and records necessary for purposes of the local jurisdiction in which it is organized. For U.S. tax purposes, a foreign DRE is treated as a branch of its owner, and its balance sheet and income statement rolls up into those of its owner, with intercompany transactions eliminating in consolidation. If the functional currency of the foreign DRE is different than that of its owner, the foreign DRE is treated as a distinct “qualified business unit,” and as such, is subject to sections 987 - 989. In specific situations, the tax fiction of the foreign DRE (i.e., its status as a deemed branch of its owner) is lifted and the foreign DRE is treated as a separate corporation. See e.g. sec. 954(d)(2) and Treas. Reg. sec. 1.954-3(b).

Shortly after the publication of Notice 98-11, the IRS issued temporary and proposed regulations addressing the transactions described in the Notice. Under those regulations, certain payments (“hybrid branch payments”) between a CFC and its hybrid branch or between hybrid branches of the CFC were treated as giving rise to subpart F income. The regulations generally provided that nonsubpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC if: (1) the hybrid branch payment reduces the foreign tax of the payor; (2) the hybrid branch payment would have been foreign personal holding company income (a category of subpart F income) if made between separate CFCs; and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payor.

The regulations also applied to other hybrid branch arrangements involving a partnership, including a CFC’s proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership or between hybrid branches of such a partnership. Under the regulations, if a partnership is treated as fiscally transparent by the CFC’s taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC’s taxing jurisdiction, the recharacterization rules are applied to treat the partnership as if it were a CFC.

The regulations also addressed the application of the same-country exception to the foreign personal holding company income rules under subpart F in the case of certain hybrid branch arrangements. Under the regulations, the same-country exception applied to payments by a CFC to a branch of a related CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax). The regulations provided additional rules regarding the application of the same-country exception in the case of certain hybrid arrangements involving a partnership.

The issuance of Notice 98-11 and the temporary and proposed regulations provoked controversy among taxpayers and members of Congress. In its version of the Internal Revenue Service Restructuring and Reform Act of 1998, the Senate included provisions that would have precluded the immediate implementation of Notice 98-11, so that Congress could consider the international tax policy issues relating to the treatment of hybrid transactions under subpart F. Prior to passage of the final version of that legislation, however, the IRS issued Notice 98-35, which withdrew Notice 98-11, and announced its intention to withdraw the temporary and proposed regulations issued thereunder and reissue substantially similar proposed regulations to be finalized no earlier than January 1, 2000. As a result, the IRS Restructuring and Reform Act, as ultimately passed, did not include these provisions.

D. Section 936

Section 936 is generally inapplicable to taxable years beginning after December 31, 1995.¹⁸² However, it is relevant to several of the case studies presented in this pamphlet. When applicable, section 936 generally provided that certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) could elect the possession tax credit, which generally eliminated the U.S. tax on certain income related to their operations in the possessions. In contrast to the foreign tax credit, the possession tax credit was a “tax sparing” credit. That is, the credit was granted whether or not the electing corporation paid income tax to the possession. Income eligible for the credit under this provision fell into two broad categories: (1) possession business income, which was derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business; and (2) qualified possession source investment income (“QPSII”), which was attributable to the investment in the possession of funds derived from the active conduct of a possession business.

To qualify for the possession tax credit for a taxable year, a domestic corporation had to satisfy two conditions. First, the corporation must have derived at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must have derived at least 75 percent of its gross income for that same period from the active conduct of a possession business.

A domestic corporation that elected the possession tax credit and that satisfied these two conditions for a taxable year generally was entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer’s possession business income and its QPSII. However, the amount of the credit attributable to possession business income was subject to limitations. Profits attributable to marketing or other similar activities did not qualify for the credit.

In 1996, the possession tax credit for QPSII was repealed and the credit for possession business income was phased out over a 10-year period. Thus, such benefits are unavailable for taxable years beginning after December 31, 2005.

¹⁸² Transition rules applied to existing credit claimants that met certain requirements through taxable years beginning before January 1, 2006.

III. SIX CASE STUDIES OF U.S. BASED MULTINATIONAL CORPORATIONS AND THE U.S. TAX BASE

Motivation for case studies

The results of the studies reviewed in Part I suggest that U.S. based multinational corporations may have tax motivations as a factor in the choice of location of their foreign direct investment. While perhaps suggestive, these studies do not identify the mechanisms by which reduced U.S. and worldwide tax liabilities might be achieved. The Joint Committee staff concluded that a review of public and private documents for specific taxpayers might help explain how the interaction between business operations and tax planning by U.S. based multinational corporations could result in low reported average U.S. and worldwide tax rates by certain of those corporations.

Selection of the case studies

The Joint Committee staff reviewed public documents filed by more than 100 public corporations with significant operations and sales both in the United States and abroad. The Joint Committee staff selected each of the six cases reviewed below, in part, on the basis of reports to their shareholders that the corporation had an effective (i.e., average) tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999. The Joint Committee staff's selections were drawn from different industries. It is important to emphasize that the six case studies do not represent a random selection of U.S. based multinational corporations.

Because the Joint Committee staff selected these cases non-randomly, the descriptions below should not be interpreted as a general description of how U.S. multinational corporations organize their business or account for their tax obligations. Each business is in many ways unique in its circumstances, given its historical investment decisions and its plans for future investments. Nevertheless, the Joint Committee staff hopes that even a small sample of case studies may identify certain common elements to business operations and tax planning that could have wider applicability among U.S. multinational corporations.

Method of the case studies

The case studies that follow are based upon the Joint Committee staff's review of some or all of the following.

- Corporate annual reports.
- Corporate form 10-K filed with the Securities and Exchange Commission.
- Review of corporate income tax Form 1120 including Form 1118.
- Review of IRS Form 5471 (information return of CFC).
- Review of IRS Form 8858 (information return for foreign DRE).
- Review of IRS Form 8865 (information return for controlled foreign partnerships).
- Review of taxpayers' section 6662(e) transfer pricing documentation.
- Review of other transfer pricing material submitted by the taxpayer to the IRS (including contractual arrangements and both foreign and U.S. APAs).
- Review of IRS internal studies, and studies of IRS consultants, related to the taxpayers' businesses and transfer pricing.
- Review of IRS risk analysis prepared in anticipation of commencing the relevant audit cycles (i.e., the audits coinciding with the study period).
- Review of IRS appellate materials involving the taxpayers.
- Review of prior audit settlement agreements between taxpayers and the IRS.
- Review of organization charts depicting the worldwide legal structures of the taxpayers.
- Review of supply chain flows depicting the nature of the taxpayers' international related-party activities.
- Review of material submitted by the taxpayer to the IRS related to license agreements, royalty rates, profit splits, etc.
- Interviews with the IRS examination teams familiar with the taxpayers' returns.

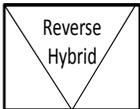
The Joint Committee staff did not speak to or request information from the taxpayers selected for the case studies. The Joint Committee staff's discussion of issues is based upon the facts as reported and is not a commentary on the correctness of any specific position taken by the taxpayer. The Joint Committee staff does not view the case studies as an investigation of the tax position of any specific taxpayer, but rather views the case studies as facilitating the identification and discussion of business structures that affect any taxpayer's U.S. and worldwide tax liability.

Presentation of the case studies

To discuss the relative sizes of items such as worldwide income, worldwide tax payments, royalty payments, and other aggregate dollar amounts, all case studies are presented as if each multinational corporation had average global revenue of \$100 billion during the taxpayers' study period. While business structures are described, these may often represent simplified versions of the actual business structures that the Joint Committee staff found. The case studies are presented in a manner so as not to be associated with or identify directly or indirectly any particular taxpayer.

In presenting the case studies, the Joint Committee staff uses certain common terms and pictograms. The glossary, at the back of this pamphlet, presents a simplified, non-technical glossary of some of these common terms. The legend, below, provides the pictograms common to the various figures in the case studies.

Legend

	U.S. – Corporation
	U.S. – Partnership
	U.S. – Controlled foreign corporation Foreign - Corporation
	U.S. – Unrelated service provider Foreign – Unrelated service provider
	U.S. – Disregarded entity (branch) Foreign – Corporation
	U.S. – Controlled foreign corporation Foreign – Partnership (Flow -Through Entity)

A. Alpha Company

Overview of the company

Alpha Company (“Alpha”) is a leading global manufacturer and marketer of consumer products. The company sells its products in over 100 countries and has a reputation for quality, design innovation, and value.

Alpha worldwide sales for the study period averaged \$100 billion annually.¹⁸³ Of these sales, an average of \$60 billion were to U.S. customers and \$25 billion were to customers in Europe. Over the study period, Alpha’s average annual U.S. GAAP consolidated income before income taxes was \$8 billion. Although an average of 60 percent of the sales over the study period were made to customers in the United States, the company reported an average of less than 30 percent of its earnings before income taxes in the United States.

Alpha reported a worldwide average tax rate of between 15 and 20 percent for the study period. The company’s average U.S. Federal and State tax expense over the study period was \$200 million. Foreign taxes averaged \$1 billion.

The company reported unremitted earnings of subsidiaries outside the United States of over \$35 billion at the end of the study period. For financial statement purposes, no U.S. income taxes were accrued on those earnings, as the company reports that its intention is to permanently reinvest the earnings or to repatriate the earnings only when possible to do so at a minimal additional tax cost.

Alpha has many employees worldwide. It has manufacturing operations in several countries, including the United States, Latin America, and Asia. Additionally, the company relies on third-party contract manufacturers. Most of Alpha’s R&D activities are performed in the United States, with less than five percent of its R&D employees located in China.

Global Tax Structure

Alpha and its domestic affiliates (collectively “Alpha U.S.”) file a U.S. consolidated tax return. Alpha operates throughout the world through CFCs, DREs, and foreign branches. Alpha has modified its legal and operational structure frequently, running operations through different jurisdictions to take advantage of tax and operational benefits. During the study period, transactions between the following key entities made up the majority of Alpha’s deferred foreign earnings:

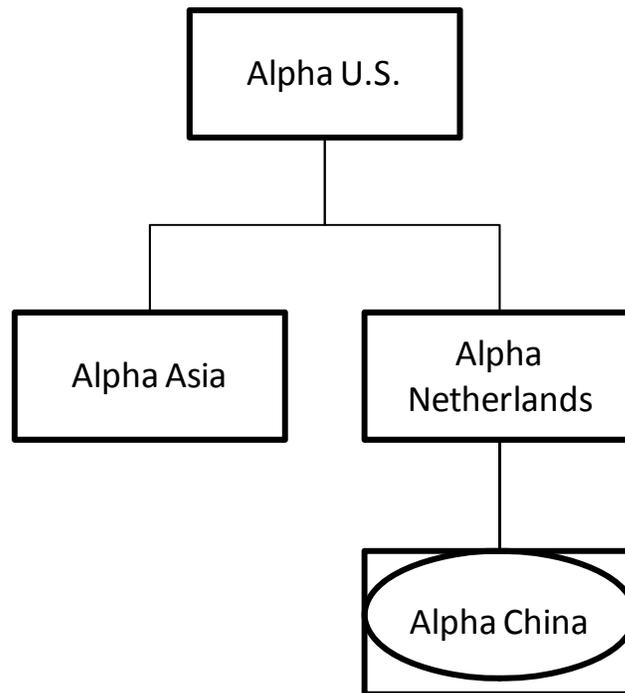
- Alpha Asia Limited (“Alpha Asia”) is a CFC, 99.9 percent of which is indirectly owned by Alpha U.S. This CFC conducts much of Alpha’s manufacturing through the use of third-party contract manufacturers.

¹⁸³ This amount is presumed for purposes of presenting the case study.

- Alpha Holdings BV (“Alpha Netherlands”) is a CFC, 100 percent of which is indirectly owned by Alpha U.S. This CFC owns several Alpha Chinese manufacturing entities organized as separate DREs.
- Alpha (China) Co., Ltd. (“Alpha China”) is a Chinese DRE wholly owned by Alpha Netherlands. It is the main manufacturing company in a group of Chinese manufacturing DREs organized under Alpha Netherlands. Alpha China makes up a majority of Alpha Netherlands’ income over the study period.

The abbreviated global structure is illustrated in Figure 3 below.

Figure 3



As a result of a check-the-box election, Alpha China is treated, for U.S. tax purposes, as a branch of Alpha Netherlands. However, the discussion that follows focuses on the functions actually performed by each CFC or DRE.

Alpha Asia

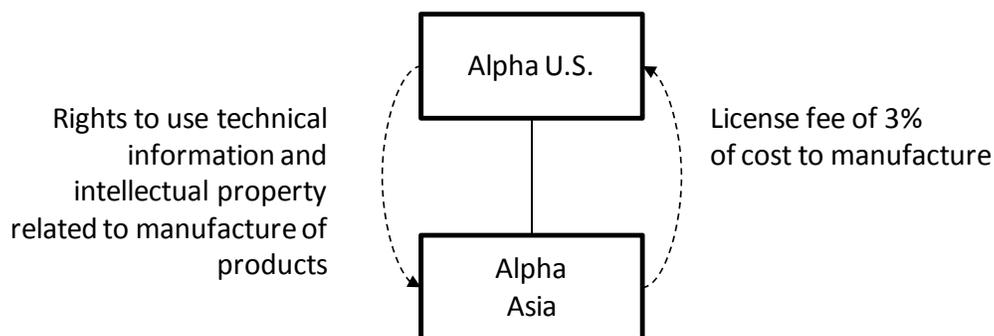
Alpha Asia is responsible for both the manufacturing and purchasing of many of the products sold by Alpha globally. Manufactured products include goods manufactured by contract manufacturers that Alpha Asia controls or oversees. Purchased products include off-the-shelf products where Alpha Asia is not significantly involved in the manufacturing process. Manufactured products account for over 85 percent of Alpha Asia’s total cost of goods sold. Alpha Asia performs all manufacturing of these products through the use of third-party contract manufacturers. Alpha Asia bears the risk and responsibility for: (1) contractor evaluation,

selection, management, and supervision; (2) entering into contract manufacturing agreements; (3) product quality control; (4) product development and sourcing; (5) continuous improvement of the manufacturing process; (6) buying and negotiations; (7) project management; (8) capacity planning and contractor scheduling; (9) engineering support; (10) negotiating commercial and warranty contracts; (11) logistics and delivery; (12) re-sourcing product; and (13) monthly reporting.

Alpha Asia bears the inventory risk for both the raw materials and finished product and generally obtains insurance for the raw materials used and the inventory produced by its contract manufacturers. It maintains an Asian office with fewer than 50 employees, and operates representative offices in several Asian locations including Taiwan, South Korea, and several locations in China. Employees of the representative offices perform principally supply sourcing, engineering, supply chain support, and quality control. The engineering employees are generally not employees of Alpha Asia; but rather, they are employees of another Alpha CFC located in China.

Alpha U.S. personnel conduct R&D activities for Alpha Asia. These activities, conducted in the United States, include new product development, industrial design, packaging, quality testing, and value analysis engineering. Alpha U.S. agrees to make available Alpha technical information and other intangible property to enable Alpha Asia and its contract manufacturers to design, develop, and manufacture the products in the most cost-efficient and productive manner. Technical information licensed includes technology know-how and design, while other intangible property includes quality control standards and procedures and training. In exchange for the use of this technical information and intangible property, Alpha Asia pays a license fee equal to three percent of the standard cost of production for manufactured products or of the purchase price for purchased products. The pricing was developed using the comparable uncontrolled transactions method. Alpha Asia paid average annual royalties to Alpha U.S. of \$480 million. The license between Alpha U.S. and Alpha Asia is illustrated in Figure 4 below.

Figure 4



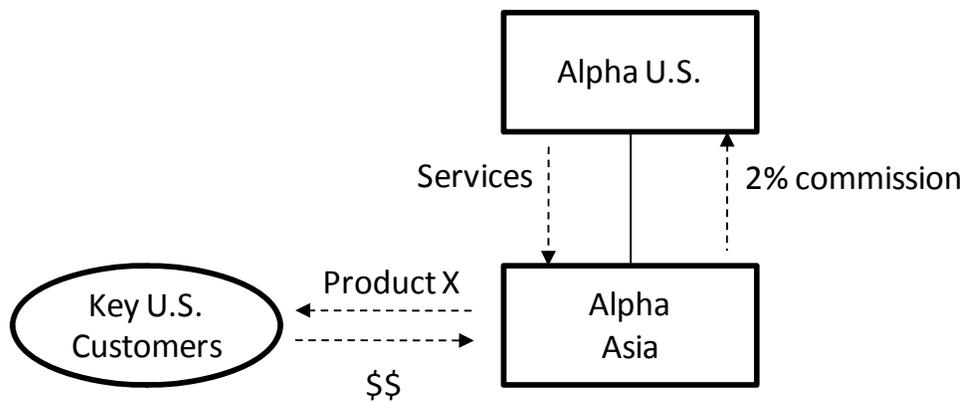
Alpha Asia sells its products to Alpha U.S. in addition to selling directly to several of Alpha’s key U.S. customers and to other Alpha CFCs for distribution in foreign markets. Alpha Asia averaged \$21 billion in sales over the study period. On average 65 percent of all Alpha Asia’s sales are made to Alpha U.S., and 20 percent are to other foreign CFCs and DREs for

sales in foreign markets. Related party sales are made at cost plus six percent for purchased products and cost plus nine percent for manufactured products. Alpha uses the comparable profits method to determine the transfer price of goods sold from Alpha Asia to related parties. In determining the transfer price, Alpha Asia was selected as the tested party.

The remaining 15 percent of Alpha Asia’s sales are made directly to Alpha’s key U.S. customers. These products are sold at cost plus a 30 percent markup. Alpha U.S. provides sales and marketing, customer support, and post-sales services in addition to setting the prices for product sales from Alpha Asia. For these services, Alpha Asia pays a commission of two percent to Alpha U.S. The commission was determined using the comparable profits method with Alpha U.S. selected as the tested party as Alpha determined that Alpha U.S. should be expected to earn a level of profit that is similar to commission services performed by independent firms.

Figure 5 below illustrates the sales of product by Alpha Asia to U.S. key customers and the commission payment to Alpha U.S.

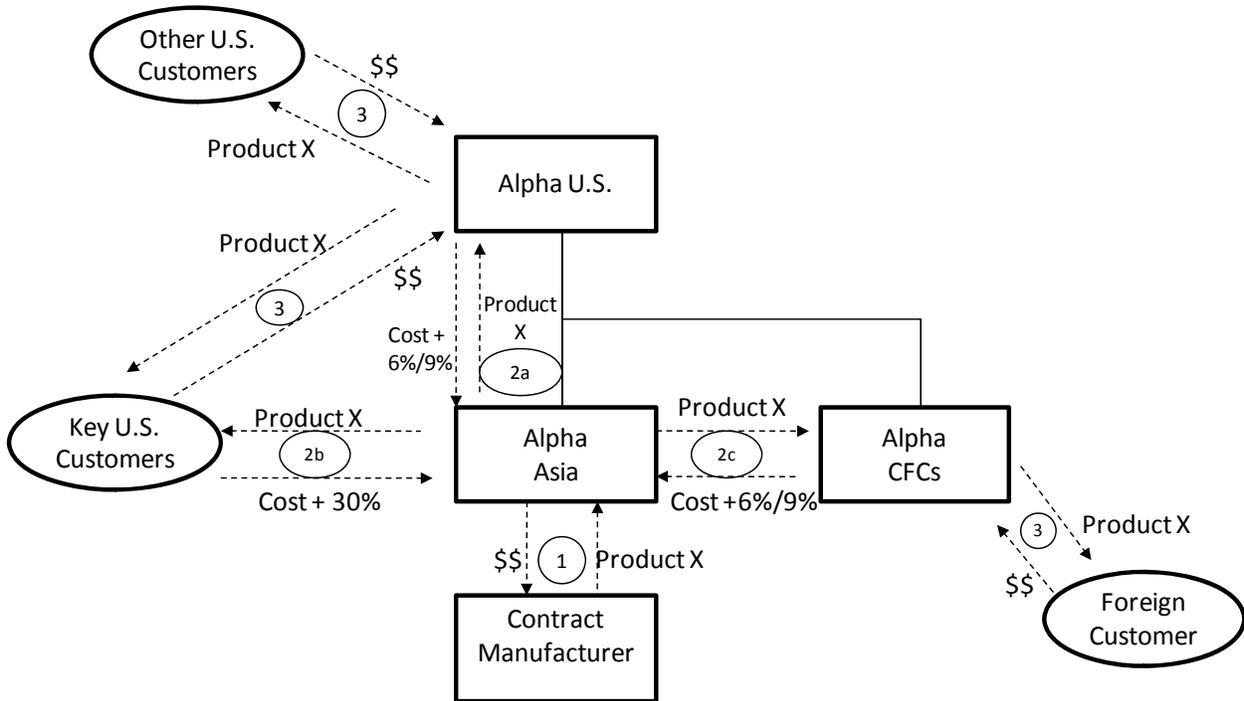
Figure 5



Ultimately, Alpha Asia retains about five percent of the profit on sales to related parties, and about 28 percent of the profit on sales it makes directly to key U.S. customers. It had annual average profit over the study period of \$1.5 billion. It pays no tax in its country of organization, and does not pay tax in the United States on these profits until such time as it pays dividends to Alpha U.S. At the end of the study period, Alpha Asia reported \$6 billion of accumulated earnings and profits.

The Alpha Asia operations are illustrated in Figure 6 below.

Figure 6



In step 1 of Figure 6, Alpha Asia engages the third-party contract manufacturer to assist in the manufacturing of Product X, or purchases off-the-shelf products from third-party suppliers. Step 2a illustrates the sales of Product X from Alpha Asia to Alpha U.S. for cost plus a six or nine percent markup. In step 2b, Alpha Asia sells Product X directly to key U.S. customers for cost plus a 30 percent markup. In step 2c, Alpha Asia sells Product X to other Alpha CFCs at cost plus six or nine percent markup for distribution by the CFCs in foreign markets. Step 3 illustrates the resale of Product X by Alpha U.S. to key U.S. customers and other U.S. customers, and the resale of Product X by Alpha CFCs to foreign customers. Although the transfer of title to Product X follows steps 1-3, Product X is generally physically transferred directly from the third-party contract manufacturers to U.S. and foreign customers.

In summary, Alpha U.S. develops new products and retains the ownership of the intangible property in the United States. Alpha U.S. licenses the intangible property necessary for the manufacture of products to Alpha Asia in exchange for a license fee of three percent of the manufacturing cost. Alpha Asia purchases off-the-shelf products and manufactures, through hundreds of third-party contract manufacturers, products for sale by Alpha globally. Alpha Asia then sells the product through three main channels:

- Sales to Alpha U.S. at either a six or nine percent markup on cost for distribution to U.S. customers.
- Sales to key U.S. customers at cost plus 30 percent. Alpha U.S. receives a two percent commission on these direct sales.

- Sales to other Alpha CFCs at either a six or nine percent markup on cost for distribution in foreign markets.

Alpha U.S. recognizes income for U.S. tax purposes from three sources - the gross margin it earns on sales of Product X to U.S. customers, the commission it receives on the direct sales from Alpha Asia to key U.S. customers, and on the license fee it receives from Alpha Asia for the intangible property rights related to the manufacture of Product X. Alpha U.S. incurs two types of currently deductible expenses that reduce U.S. taxable income. These expenses are for R&D and for sales and marketing expenses incurred to make the sales to U.S. customers and to arrange the direct sales from Alpha Asia to key U.S. customers. Additionally, Alpha U.S. may qualify for a U.S. income tax credit for some or all of its R&D costs.

Alpha Asia recognizes income in its country of origin on profits from its sales of product, reduced by the license fees and commissions paid to Alpha U.S. During the study period, Alpha Asia paid no foreign income tax on its earnings.

Alpha Netherlands

Not only does Alpha use third-party contract manufacturers, it also manufactures product in-house in several locations including Latin America and China. Alpha China is one such manufacturer and is organized as a DRE under Alpha Netherlands. Alpha China's manufacturing operations make up a large portion of the activity reported by Alpha Netherlands. Although the majority of R&D activity is performed in the United States by employees of Alpha U.S., Alpha employs some engineers and other professionals in China that perform a small percentage of R&D activity, including activity related to product testing.

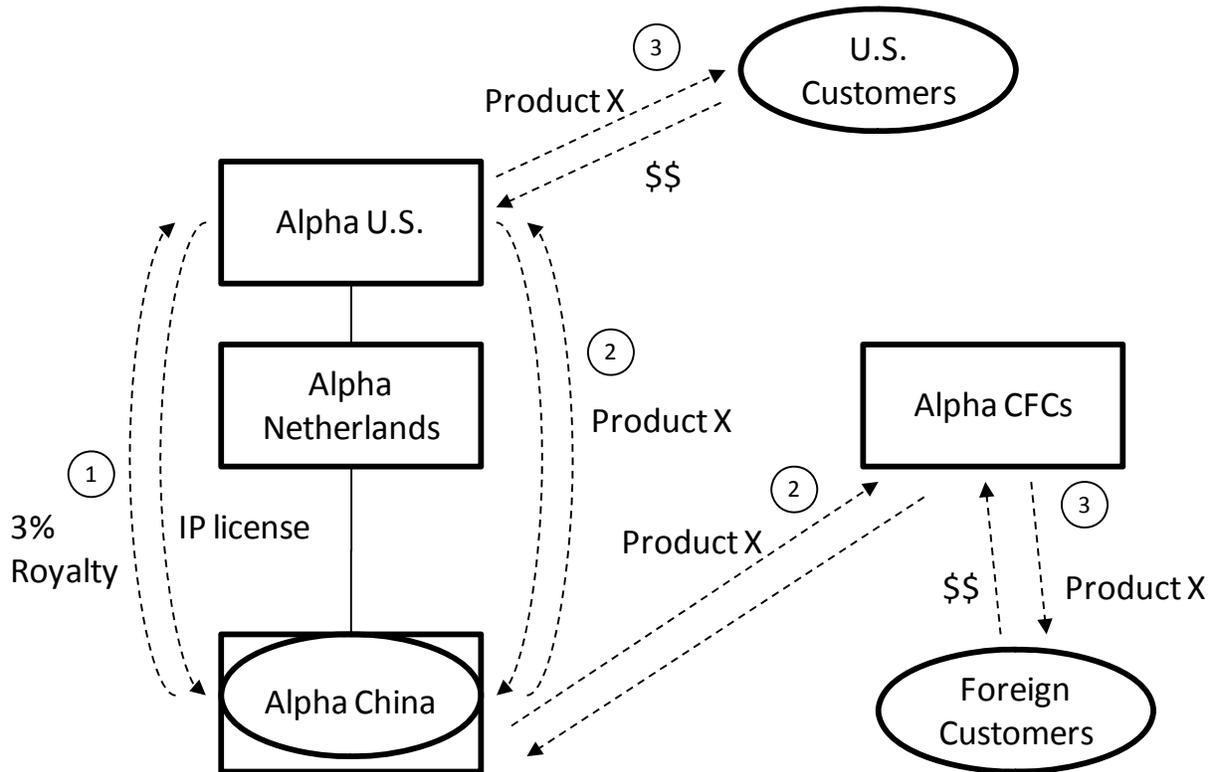
Alpha has historically moved operations and changed the legal structure as necessary to take advantage of additional tax and operational benefits in various jurisdictions. The Chinese structure has developed over time and the DRE structure under Alpha Netherlands expanded its operations over the study period. Alpha moved some of the in-house manufacturing operations historically done in the United States to China. Alpha Netherlands reported average annual sales of approximately \$6 billion in the early study period years, but more than \$10 billion in the final year studied, reflecting the expanding activities of the DREs.

The technology and intangible property rights are owned by Alpha U.S. and licensed to Alpha China. In return, Alpha China pays a royalty to Alpha U.S. of approximately three percent of sales. The average annual royalty paid to Alpha U.S. was \$115 million over the study period.

Over 80 percent of the sales reported by Alpha China in the study period were made to related parties, with nearly 50 percent of related party sales made to Alpha U.S. Alpha China's average annual sales for the study period were \$4 billion.

The operations of Alpha China are illustrated in Figure 7 below.

Figure 7



In step 1 of Figure 7, Alpha China pays a royalty of three percent of its sales in return for Alpha U.S. licensing its manufacturing technology and other intangible property rights to Alpha China. Step 2 illustrates the sale of Product X from Alpha China to Alpha U.S. and from Alpha China to Alpha CFCs. Step 3 illustrates the resale of Product X by the Alpha CFCs to foreign customers and the resale of Product X by Alpha U.S. to U.S. customers.

Alpha U.S. recognizes income for U.S. tax purposes from two sources - the gross margin it earns on sales of Product X to U.S. customers and on the royalty it receives from Alpha Asia for the intangible property rights related to the manufacture of Product X. Alpha U.S. incurs two types of currently deductible expenses that reduce U.S. taxable income. These expenses are for R&D and for sales and marketing expenses incurred to make the sales to U.S. customers. Additionally, Alpha U.S. may qualify for a U.S. income tax credit for some or all of its R&D costs.

Alpha China recognizes income in its country of origin on profits from its sales of product, reduced by the license fees paid to Alpha U.S. Alpha Netherlands reported nearly \$5 billion of accumulated earnings and profits at the end of the study period. Alpha Netherlands average earnings before taxes were \$1 billion, and it reported an average of just under \$50 million of subpart F income annually over the study period. Alpha Netherlands average foreign taxes were \$50 million annually.

Summary

Alpha utilizes various manufacturing structures outside of the United States to retain profit in low-tax jurisdictions. The bulk of deferred income relates to its manufacturing operations in Asia. Alpha Asia is responsible for the manufacture of products through the use of hundreds of third-party contract manufacturers. Alpha Asia bears the risk related to the manufacture and purchase of raw materials and finished inventory. This structure allows Alpha to accrue significant earnings, including earnings from sales to United States customers, in a jurisdiction where Alpha pays no income tax. Alpha U.S. receives a three percent license fee for providing the product development and a majority of the engineering and manufacturing technology. Additionally Alpha U.S. earns a two percent commission on sales made directly to its key U.S. customers on products developed and marketed by the U.S. group.

Alpha moved some of its in-house manufacturing operations from the United States to China to benefit from additional tax and operational savings. Alpha U.S. earns a royalty fee of three percent on products manufactured within Alpha China and other similar manufacturing DREs. The majority of the product development, marketing, and other intangible property is located in the United States. The Alpha Netherlands operation, which houses the Chinese manufacturing DREs, has an average tax rate of just over three percent.

Although nearly 60 percent of Alpha's sales are to U.S. customers, an average of less than 30 percent of its earnings before income tax are reported as U.S. earnings. At the end of the study period, Alpha reported permanently reinvested earnings in excess of \$35 billion. Alpha's foreign earnings help it achieve an average worldwide tax rate of 19.5 percent compared to the U.S. Federal statutory tax rate of 35 percent.

B. Bravo Company

Overview of the company

Bravo Company (“Bravo”) is a publicly traded U.S.-based multinational company that focuses on the sale of industrial technology products and services. For the study period, Bravo had average global revenues of \$100 billion¹⁸⁴, including \$85 billion of net product sales and \$15 billion attributable to services. Of the product sales, 50 percent were sales in the United States and Canada, 20 to 25 percent to European customers, 15 percent to Asia Pacific customers, and the remaining sales to customers in developing markets. For the same period, Bravo’s average U.S. GAAP consolidated income (i.e., income reported to shareholders) before income taxes was \$30 billion, of which \$10 billion was attributable to U.S. operations and \$20 billion was attributable to foreign operations. The average total worldwide income tax expense for the period was \$6 billion, including \$5 billion U.S. Federal and state tax expense and \$1 billion of foreign tax expense, resulting in a worldwide average tax rate of 20 percent. Bravo does not include in its worldwide income tax expense or its worldwide average tax rate any tax on accumulated foreign earnings of approximately \$60 billion because these are earnings for which the company has asserted permanent reinvestment offshore.

Bravo employs many people worldwide. Substantially all of Bravo’s manufacturing is performed by third-party contract manufacturers, not by Bravo employees. Bravo’s employees primarily engage in R&D activities such as engineering and design, and other activities including supply-chain management, marketing, sales, and distribution. For the study period, Bravo’s average global R&D expense was approximately \$15 billion. While R&D is funded by both Bravo’s U.S. and foreign operations, substantially all of its R&D activities were performed by its U.S. employees located within the United States.

Global tax structure

Bravo and its domestic affiliates (collectively “Bravo U.S.”) file a U.S. consolidated tax return. Bravo operates globally through controlled foreign corporations (“CFCs”), foreign disregarded entities (“DREs”) and foreign branches. Transactions among three entities generate the vast majority of Bravo’s U.S. tax-deferred foreign earnings. These entities are as follows:

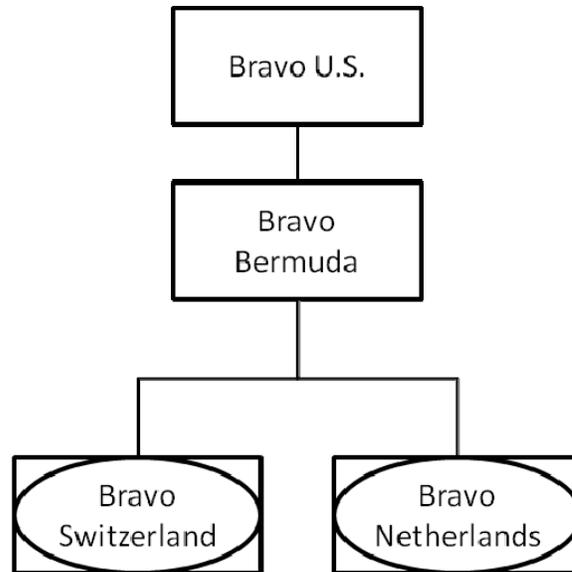
- Bravo Holdings (Bermuda) Ltd. (“Bravo Bermuda”) is a wholly owned CFC directly held by Bravo U.S.
- Bravo Company SARL (“Bravo Switzerland”) is a Swiss DRE wholly owned by Bravo Bermuda. It is the economic owner and the licensor of the rights to certain Bravo intangible property.
- Bravo Company BV (“Bravo Netherlands”) is a Dutch DRE wholly owned by Bravo Bermuda. It is an operating company that is the licensee of the intangible property

¹⁸⁴ This amount is presumed for purposes of presenting the case study.

held by Bravo Switzerland and is responsible for the manufacture (through outsourcing), marketing, sale and distribution of certain Bravo products.

Bravo Switzerland and Bravo Netherlands are DREs as a result of making check-the-box elections. This abbreviated tax structure is illustrated in Figure 8, below.

Figure 8



Because Bravo Switzerland and Bravo Netherlands are DREs, for U.S. tax purposes Bravo Bermuda is generally treated as performing all of the activities of Bravo Switzerland and Bravo Netherlands. However, the discussion that follows focuses on the functions actually performed by each DRE.

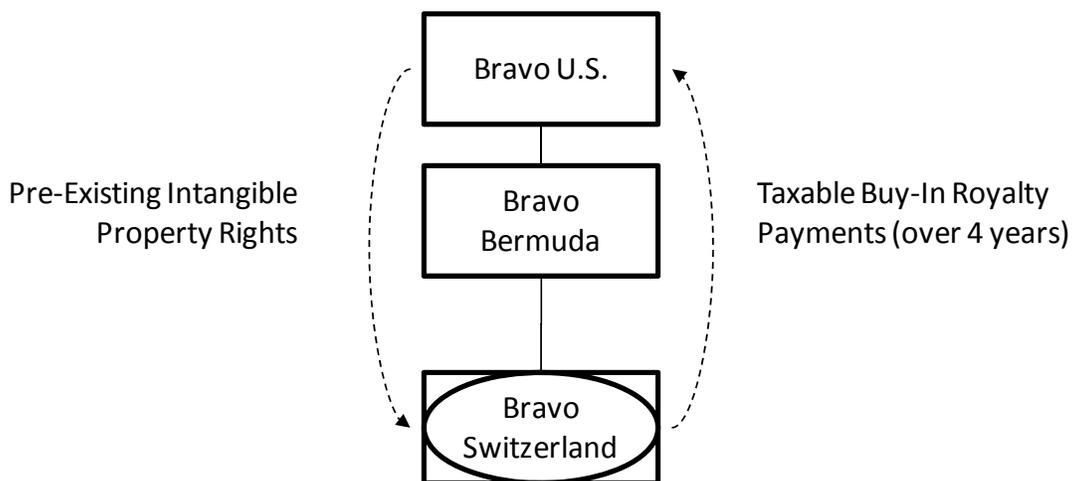
Ownership and exploitation of intangible property

In the 1990's, Bravo decided that Bravo U.S. would retain primary responsibility for the manufacture and sale of certain existing and newly developed Bravo product lines worldwide and that Bravo Switzerland would have primary responsibility for the manufacture and sale of other existing and newly developed product lines worldwide. To implement this plan, a cost sharing agreement between Bravo U.S and Bravo Switzerland was executed. Consistent with the strategic decision to align along product lines, the cost sharing agreement was originally structured based on the expectation that Bravo U.S. would retain the global intangible property

rights to certain pre-existing product lines, and Bravo Switzerland would acquire the global intangible property rights to manufacture and sell certain other pre-existing product lines.¹⁸⁵

To allow Bravo Switzerland to use pre-existing intangible property made available through the cost sharing agreement, Bravo Switzerland made a buy-in payment to Bravo U.S. in the form of a declining royalty over a specified time period pursuant to a license agreement. The license agreement established the royalty rate using a residual profit split method with the royalty rate incrementally adjusted downward to zero percent over the useful life of the pre-existing intangibles (i.e., the period over which the intangible property rights to pre-existing intangibles become obsolete without further development). Because Bravo competes in the technology industry, Bravo took the position that the useful life of these pre-existing intangibles was three to four years. Over this useful life, Bravo Switzerland paid several billion dollars in total royalties under the license agreement. These royalties were taxable in the United States upon inclusion. While the royalties would have generated a current deduction in Switzerland, any tax benefit of such deductions would have been realized at the Swiss tax rate, which is generally much lower than that of the United States.¹⁸⁶ This initial investment in the form of the buy-in payment was fully recovered by Bravo Switzerland within three years. The Bravo Switzerland buy-in payment is illustrated in Figure 9 below.

Figure 9



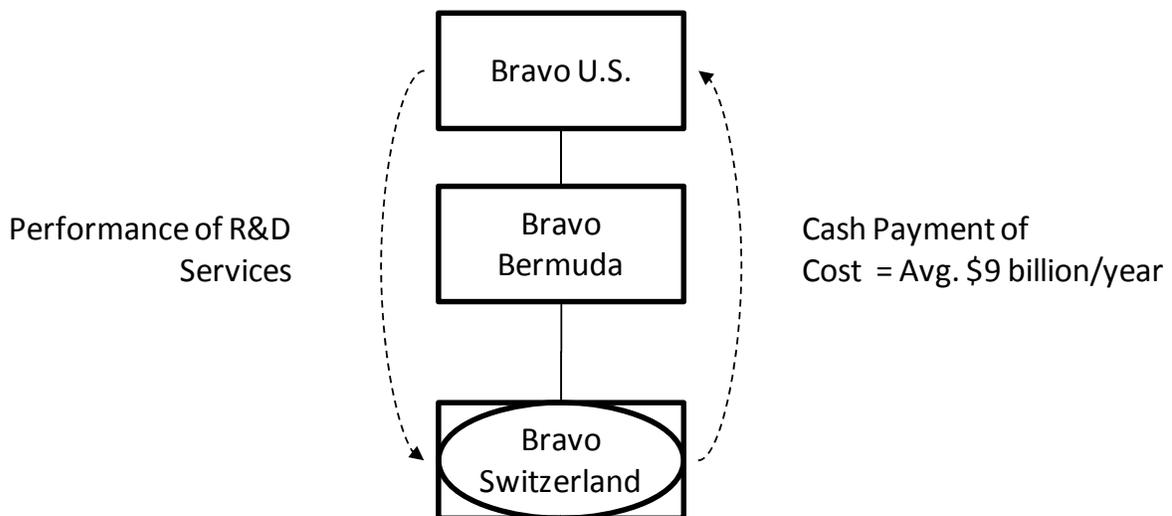
¹⁸⁵ According to the license agreement, these intangible property rights include the right to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license and otherwise commercially exploit those products under the cost sharing agreement.

¹⁸⁶ The royalties were also currently deductible at Bravo Switzerland for U.S. earnings and profits purposes rather than creating tax basis in an intangible asset; therefore, the portion of the pre-existing worldwide intangibles attributable to the United States did not result in an income inclusion relating to a CFC investment in U.S. property under section 956.

The terms of the initial buy-in and cost sharing agreement were based on the expectation that Bravo Switzerland's products covered under the cost sharing agreement would make up less than one-third of total Bravo sales worldwide, and Bravo U.S.'s products covered under the cost sharing agreement would make up more than two-thirds of total Bravo sales worldwide. Hence, the share of R&D costs funded by each party was split according to these same ratios. However, over time, as global sales changed, Bravo Switzerland's sales as a percentage of total Bravo sales worldwide grew significantly, while Bravo U.S.'s sales as a percentage of total Bravo sales worldwide declined by a corresponding amount. To reflect this change, payments under the cost sharing agreement were revised annually to update the percentage of total R&D expenditure for which Bravo U.S. and Bravo Switzerland were responsible in accordance with the Treasury regulations on cost sharing.

Although the percentage of R&D funded by Bravo Switzerland under the cost sharing agreement has increased to reflect the increase in total sales attributable to Bravo Switzerland's product lines, substantially all of the R&D activity continues to be performed in the United States by Bravo U.S. employees. Bravo Switzerland reimbursed Bravo U.S. for R&D performed on Bravo Switzerland's behalf. For the study period, Bravo Switzerland's average annual cost sharing payment to Bravo U.S. exceeded \$9 billion. These annual cost sharing payments are taxable income in the United States. As a result, they offset the benefit of any U.S. R&D expense deduction. Nonetheless, Bravo U.S. may be eligible for an R&D credit even for those expenditures reimbursed by Bravo Switzerland under the cost sharing agreement. While they are also deductible in Switzerland, any tax benefit of such deductions is realized at the Swiss tax rate, which is generally much lower than that of the United States. Figure 10 below depicts the payment made by Bravo Switzerland to Bravo U.S. for the performance of contract R&D under the cost sharing agreement.

Figure 10



In addition to organic growth, much of Bravo's historic growth has come from the acquisition of other companies. In many cases, the principal assets of the companies acquired by Bravo were U.S. owned intangible property. To the extent Bravo made the strategic decision to align a newly acquired product line (and its associated intangible property) with Bravo Switzerland, the existing license agreement and cost sharing agreement between Bravo U.S. and Bravo Switzerland were amended as necessary, and Bravo Switzerland made a buy-in payment with respect to the pre-existing intangibles and cost-shared future development costs.

Bravo Switzerland's buy-in payment with respect to the pre-existing intangibles previously acquired or developed by Bravo U.S. and its continued funding of its ratable share of the R&D performed by Bravo U.S. employees generally entitles Bravo Switzerland to all of the future profit (income in excess of the annual cost sharing payment) attributable to the product lines that it cost shares. Conversely, Bravo Switzerland also bears the risk and the cost of any future losses.

Domestic value chain

In connection with the U.S.-owned intangible property, Bravo U.S. is responsible for the manufacture and distribution of all related products.¹⁸⁷ Bravo U.S. bears all significant risks associated with the manufacture and sale of these products including: (1) product and quality risk, including the responsibility of bringing new and improved products to market and the risk that R&D may not be successful; (2) manufacturing risk throughout the manufacturing process, with regard to time to market, product quality and reliability; (3) marketing risk, including risk with respect to the reliability of certified partners; (4) inventory risk in terms of performance and obsolescence; and (5) credit risk with respect to customer sales. Bravo U.S. performs all manufacturing of these products through U.S. third-party contract manufacturers which are compensated with a payment equal to the cost plus five percent.

Bravo U.S. sells its products to unrelated customers through multiple channels. In the Americas and Asia, Bravo U.S. generally sells its products directly to third-party customers. In a limited number of markets, Bravo U.S. sells through wholly owned CFCs that serve as limited-risk distributors to unrelated third-parties. Hence, Bravo U.S. is entitled to any resulting income to the extent of the excess of the sales price (whether on sales directly to third-party customers or related limited-risk distributors) of these products over those costs attributable to the contract manufacturing fee paid to third-party contract manufacturers. Such income is taxable in the United States. For sales throughout Europe, Bravo U.S. sells its products to third-party customers through Bravo Netherlands. Although Bravo Netherlands also serves as a limited-risk distributor, it distributes these products with the assistance of other foreign DRE affiliates wholly owned by Bravo Bermuda. These DRE affiliates serve as commission agents performing marketing and other sales support services in those countries in which the Bravo Netherlands customers are located. In general, each of the distribution affiliates are compensated in a manner

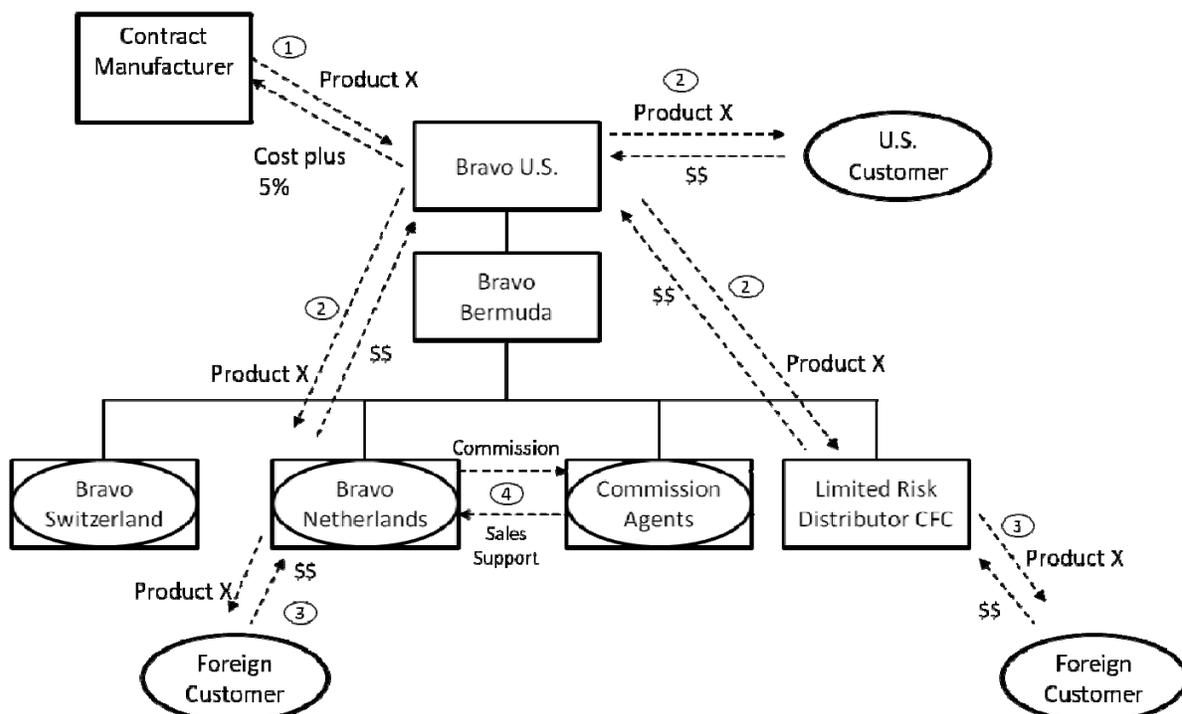
¹⁸⁷ Although the Bravo U.S. entity that owns the intangible property is different than the Bravo U.S. entity that is responsible for the manufacture and distribution of the products attributable to the intangible property, both are members of the Bravo U.S. tax consolidated group and any intercompany royalties are eliminated in consolidation for U.S. Federal tax purposes.

that ensures they receive a two-percent return on sales regardless of the ultimate profit or loss attributable to the product. Hence, Bravo Netherlands is entitled to any income attributable to the limited-risk distribution activities it performs with respect to these products to the extent the sales proceeds it receives exceed (1) the amount it paid to purchase the products for resale, and (2) the amount Bravo Netherlands pays to other DRE affiliates serving as commission agents. Such income is taxable in the Netherlands at the 25.5-percent Dutch corporate income tax rate.

To illustrate how this two-percent return is determined, assume at the beginning of a fiscal year that Bravo U.S. expects its CFC limited-risk distributors to sell its products to customers for \$100. Assume further that Bravo U.S. expects these distributors to incur \$30 of their own costs attributable to each product sale: \$4 for sales returns and allowances, \$2 for additional cost of goods sold, and \$24 for operating expenses including selling, general and administrative expenses. To provide the limited-risk distributors with a \$2 or a two-percent return on sales, Bravo U.S. sets the transfer price on the sale of the product at \$68 (\$100 gross sale less \$30 of costs less \$2 distributor profit). If it is later determined the actual costs incurred by the distributors were greater or less than what was projected at the beginning of the year, the transfer price is accordingly adjusted upwards or downwards to ensure a \$2 profit or two-percent return for the distributors. For example, if the actual costs to the distributors are \$32 as opposed to \$30, the internal transfer price on the sale between Bravo U.S. and the distributors would be adjusted to \$66 (\$100 gross sales less \$32 of costs less \$2 distributor profit) creating a corresponding increase or decrease in the taxable profit of Bravo U.S.

The Bravo U.S. domestic value chain is illustrated in Figure 11 below.

Figure 11



In step 1 of Figure 11, Bravo U.S. engages the third-party contract manufacturer to manufacture Product X. Step 2 illustrates the sale of Product X from Bravo U.S. directly to U.S. customers, to Bravo Netherlands, or to Bravo's limited-risk distributor CFCs (depending on the location of the final customer). Step 3 illustrates the resale of Product X by Bravo Netherlands and the limited-risk distributor CFCs to foreign customers. Step 4 shows the commission payment made to those DRE commission agents to the extent they assist Bravo Netherlands with the sale. Although the transfer of title to Product X follows steps 1 - 3, Product X is physically transferred directly from the third-party contract manufacturer to the U.S. and foreign customers.

For the study period, Bravo U.S. reported average domestic gross receipts on its consolidated return of \$60 billion and cost of goods sold of \$35 billion (including \$15 billion attributable to purchases from Bravo Netherlands as discussed further below).¹⁸⁸ For the same period, consolidated taxable income averaged approximately \$15 billion and the consolidated U.S. tax liability averaged \$4 billion.

Foreign value chain

In contrast to the Bravo U.S. domestic value chain in which both the ownership of the intangible property and exploitation of that intangible property are undertaken by the same U.S. taxpayer, the foreign value chain involves multiple entities across multiple jurisdictions as discussed further below.

Manufacturing process

In connection with the intangible property owned by Bravo Switzerland, Bravo Netherlands is responsible for the manufacture and distribution of all related products. In return for use of the underlying intangible property, Bravo Netherlands compensates Bravo Switzerland through a royalty, set as a percentage of Bravo Netherlands sales. This royalty percentage was computed under a residual profit split method and is reviewed annually as part of a formal transfer pricing analysis performed by a third party. For the study period, the average annual royalty was approximately \$30 billion. From a Swiss tax perspective, Bravo Switzerland's \$30 billion royalty income is reduced by the average \$10 billion cost sharing payment made to Bravo U.S. For the study period, Bravo Switzerland paid Swiss taxes annually averaging \$200 million. Since both Bravo Netherlands and Bravo Switzerland are DREs under Bravo Bermuda, the entire royalty payment is disregarded for U.S. tax purposes and, therefore, it is not evaluated under the look-through rules to determine if it should be treated as a deemed dividend under the subpart F foreign personal holding company income rules.

Bravo Netherlands by contract bears all significant risks associated with the manufacture and sale of these products including: (1) product and quality risk, including the responsibility of bringing new and improved products to market and the risk that R&D may not be successful; (2)

¹⁸⁸ The primary difference between the Bravo global revenue of \$37 billion and the Bravo U.S. gross receipts of \$21 billion is attributable to the fact that Bravo global revenues reflect sales made by Bravo U.S. as well as the Bravo foreign affiliates to third parties with appropriate intercompany eliminations. In contrast, the gross receipts of Bravo U.S. only reflect sales made by Bravo U.S., whether to third parties or foreign affiliates.

manufacturing risk throughout the manufacturing process, with regard to time to market, product quality and reliability; (3) marketing risk, including risk with respect to the reliability of certified partners; (4) inventory risk in terms of performance and obsolescence; and (5) credit risk with respect to their customer sales.

Like Bravo U.S., Bravo Netherlands performs all manufacturing of its products through the use of foreign third-party contract manufacturers under agreements in which Bravo Netherlands asserts that it manages and acts as principal. In general, Bravo Netherlands places an order with a third-party contract manufacturer for production services. Using materials that Bravo Netherlands owns, Bravo Netherlands, takes the position that, with assistance from the third-party contract manufacturer, it manufactures the product, performs the final assembly and testing, and ships the product directly to the distributor, end customer, service providers or related party. The contract manufacturers are compensated with a payment equal to the cost of labor and materials plus five percent. As discussed under “Supportive Services,” below, Bravo U.S. provides substantial supportive services to Bravo Netherlands including the provision of services as part of the Bravo Netherlands manufacturing process.

Distribution

Bravo Netherlands sells its products to unrelated customers through multiple channels in a manner similar to Bravo U.S. For sales to customers in Europe, Bravo Netherlands generally sells to third-party customers with the assistance of European DRE affiliates in certain jurisdictions, also owned by Bravo Bermuda. While some of these DRE affiliates serve as limited-risk distributors, others serve as commission agents performing marketing and other sales support services in those countries in which the Bravo Netherlands customers are located. In a limited number of markets, Bravo Netherlands sells its products through wholly owned CFCs of Bravo U.S. that serve as limited-risk distributors to unrelated third parties. For sales to the Americas, Bravo Netherlands sells its products through Bravo U.S., which also serves as a limited-risk distributor. Hence, Bravo Netherlands is entitled to any resulting income to the extent of the excess of the sales price of these products over those costs incurred attributable to (1) the royalty payment made to Bravo Switzerland, (2) the contract manufacturing fee paid to third-party contract manufacturers, and (3) and any commission paid to DRE affiliates. The amount of such income that is subject to Dutch taxation at the 25.5-percent Dutch corporate tax rate is limited pursuant to a tax ruling that Bravo Netherlands negotiated with the Dutch tax authorities. Regardless of the form of the legal arrangement, each type of distribution entity is compensated in a manner that ensures that distribution activities are compensated at a rate of two-percent return on sales.¹⁸⁹ For the study period, Bravo Netherlands had average gross receipts of \$60 billion including \$15 billion related to sales to Bravo U.S. for resale into the Americas market.

Bravo has historically maintained that its distribution activities do not generate subpart F foreign base company sales income. With respect to its sales involving the DRE affiliates owned

¹⁸⁹ See “Domestic Value Chain” for a numerical example illustrating the manner in which the Bravo Netherlands distributors are compensated.

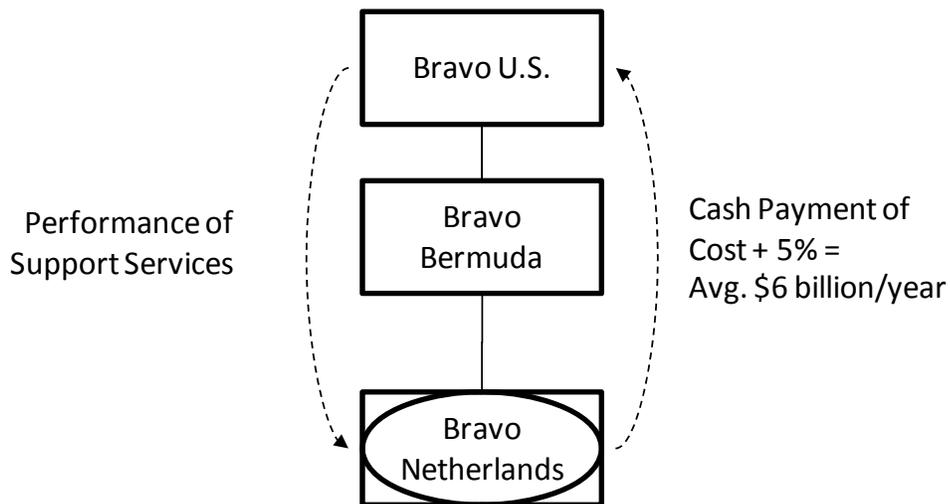
by Bravo Bermuda, these sales are disregarded and do not generate subpart F income. In contrast, Bravo Netherlands maintains that its related party sales through Bravo U.S. and the limited-risk distributor CFCs are eligible for the manufacturing exception to foreign base company sales income, because the manufacturing activities of the third-party contract manufacturers should be attributed to Bravo Netherlands.

Supportive services

Bravo Netherlands employs less than one percent of Bravo's worldwide workforce. Although information is not available as to the nature of all services performed by the employees of Bravo Netherlands, most of these employees are engaged in activities such as the processing of customer sales orders and the issuance of purchase orders to the third-party contract manufacturers. Bravo Netherlands relies upon the employees of Bravo U.S. to perform other services on its behalf including: (1) marketing support and other marketing services; (2) general sales support services; (3) factory, procurement, quality control, and similar services relating to the manufacture of goods; (4) training, support and professional services; and (5) treasury, tax and such other general and administrative services as may be mutually agreed. For these services, Bravo Netherlands generally compensates Bravo U.S. at cost plus five percent. For the study period, average compensation paid by Bravo Netherlands to Bravo U.S. for the performance of supportive services was \$6 billion. These payments are taxable in the United States to Bravo U.S. to the extent they exceed the associated deductions on the U.S. tax return. While these payments are also deductible in the Netherlands, any tax benefit of such deductions would be realized at the Dutch tax rate, which is less than three-quarters that of the United States.

Payments made by Bravo Netherlands to Bravo U.S. for the performance of supportive services are illustrated in Figure 12 below.

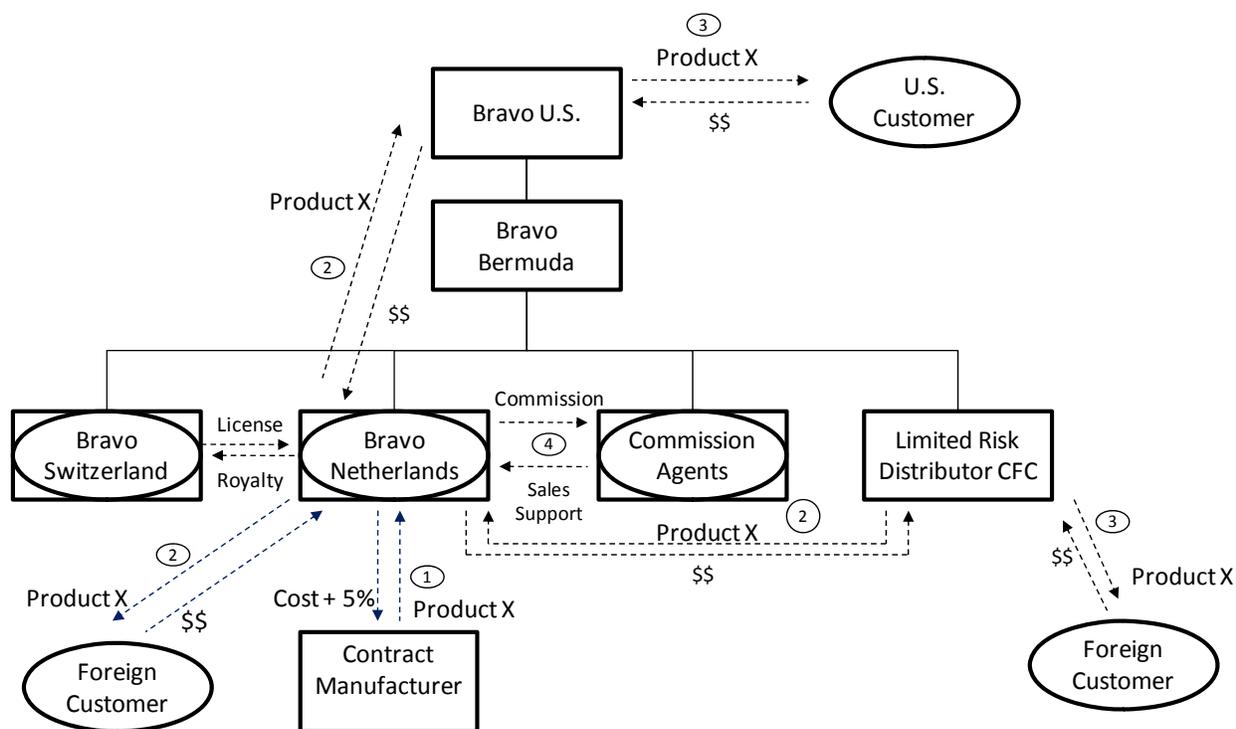
Figure 12



As noted above, Bravo Bermuda’s function is to serve as the holding company for Bravo Switzerland, Bravo Netherlands and many of the Bravo DREs that are limited-risk distributors and commission agents. Since each of these entities are generally disregarded as separate from Bravo Bermuda from a U.S. tax perspective, all of their operating activities and tax attributes flow up to Bravo Bermuda. For the study period, Bravo Bermuda reported average gross receipts of \$65 billion, average current year E&P of \$20 billion, and average current year cash taxes paid of \$700 million collectively representing the activities of Bravo Switzerland, Bravo Netherlands and the other DRE commission agents. It has approximately \$70 billion of accumulated non-previously taxed earnings and profits.

The Bravo foreign value chain is illustrated in Figure 13 below.

Figure 13



In step 1 of Figure 13, Bravo Netherlands engages the third-party contract manufacturer to assist with the manufacturing of Product X. Step 2 illustrates the sale of Product X from Bravo Netherlands directly to foreign customers as well as to Bravo U.S. and the Bravo limited-risk distributor CFCs. Step 3 illustrates the resale of Product X by Bravo U.S. and the Bravo limited risk distributor CFCs to foreign customers. Step 4 shows the commission payment made to DRE commission agents to the extent they assist Bravo Netherlands with the sale. Although the transfer of title to Product X follows steps 1 - 3, Product X is physically transferred directly from the third-party contract manufacturers to the U.S. and foreign customers.

Summary

With significant assistance from Bravo U.S. through the performance of supportive services, Bravo Netherland's use of third-party contract manufacturers and limited-risk distributors - each bearing little risk and functioning in the capacity of service providers - has resulted in the bulk of the foreign manufacturing and sales income accruing to Bravo Netherlands. This includes earnings attributable to sales to Bravo U.S. customers for which Bravo U.S. receives only a limited-risk distributor two-percent return on sales. Although Bravo Netherland's taxable income in the Netherlands is subject to a 25.5-percent tax rate, the Dutch tax base of Bravo Netherlands is substantially reduced by the annual royalty payment that Bravo Netherlands pays to Bravo Switzerland in return for the use of the intangible property rights associated with Bravo Switzerland's cost shared products. As a result of Bravo Switzerland making taxable cost sharing payments to Bravo U.S. with respect to R&D performed by Bravo U.S. employees, Bravo Switzerland's intangible property rights entitle it to retain the vast majority of these profits offshore where they are permanently reinvested. The average Swiss tax rate on these earnings in Switzerland has been less than five percent over the study period possibly due to a favorable Swiss tax ruling.¹⁹⁰ Earnings for which Bravo has asserted permanent reinvestment offshore - reflecting the Company's expectations that they will never be subject to U.S. taxation - are approximately \$60 billion.

Although less than three percent of Bravo's global workforce is abroad, this structure permits Bravo to earn and keep more than half of its taxable income offshore where it is subject to very low levels of taxation (i.e., the averaged blended cash tax rate on current earnings and profits captured within this foreign structure was less than four percent). Less than half of its taxable income is earned in the United States, where it is subject to tax at a 35-percent Federal tax rate. As a result, Bravo had a worldwide average tax rate for the study period of 20 percent as compared to the U.S. federal statutory tax rate of 35 percent.

¹⁹⁰ The tax rate was determined based on cash taxes paid as a percentage of the earnings and profits attributable to Bravo Switzerland.

C. Charlie Company

Overview of the company

Charlie Corporation is a publicly traded U.S. corporation engaged in manufacturing industrial products. The company's business comprises two segments, one for Product X and the other for Product Y. The Product X segment contributes approximately half of the gross sales of the company, worldwide.

For the study period, Charlie had average global net sales of \$100 billion.¹⁹¹ More than 60 percent of product sales were to customers in the United States. Europe accounted for more than 20 percent. For the same period, Charlie's average U.S. GAAP consolidated income before income taxes was \$7.5 billion, of which \$750 million (10 percent) was attributed to U.S. operations and \$6.75 billion (90 percent) was attributed to foreign operations.

The average total U.S. GAAP worldwide tax provision for the period was \$575 million, including U.S. Federal and State tax expense of \$35 million and foreign tax expense of \$540 million, resulting in a worldwide average tax rate of less than 10 percent. This worldwide average tax rate included the benefit of having no U.S. residual tax accrued on foreign earnings in excess of \$30 billion for which the company has asserted permanent reinvestment.

Global tax structure

Charlie Company and its domestic affiliates file a consolidated tax return. Charlie operates throughout the world through CFCs, DREs, foreign branches, and partnerships.

The role of the Product X segment in contributing to a low average tax rate for the company during the study period is the focus of this case study. It is not known how many of its employees are engaged in the Product X business segment, or where those employees are located. During this period, almost all research and development was conducted in the United States, and almost all manufacturing was performed in Puerto Rico. Customer service is available worldwide, but is coordinated through the United States, and follows business models mandated by the U.S. parent.

Acquisitions of numerous competitors have been made, including competitors' operations in Puerto Rico. As the acquired business groups and operations were integrated into Charlie's structure, the portion of corporate goodwill has increased steadily, according to the company's annual reports.

The majority of Charlie's U.S. tax-deferred foreign earnings are generated through the following entities:

- Charlie Company ("Charlie U.S."), the U.S. parent. It owns all patents and trademarks, and developed the global distribution network for Product X.

¹⁹¹ This amount is presumed for purposes of presenting the case study.

- Charlie Co. PR (U.S.), (“Charlie P.R.”) a U.S. corporation that ran the Product X manufacturing operations in Puerto Rico.
- Charlie Mfg GmbH, a Swiss company (“Charlie Switzerland”), is wholly owned by Charlie U.S., and is successor to the manufacturing operations of Charlie Co., PR (U.S.).
- Charlie Cayman, a wholly owned subsidiary of Charlie Switzerland and a DRE. It runs the manufacturing operations formerly owned by Charlie P.R.

Puerto Rico Manufacturing

Historically, almost all products sold by the Product X segment have been manufactured by facilities in Puerto Rico, operated by Charlie PR, a U.S. corporation operating as a “possessions corporation.” In doing so, Charlie was able to avail itself of various tax incentives, including the possessions credit under section 936. The finished Product X goods were shipped to the United States for distribution both within the United States and worldwide.

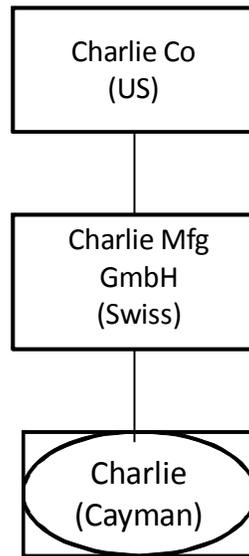
All products were purchased by Charlie U.S. from Charlie PR., which produced the goods at its manufacturing and assembly facilities in Puerto Rico. The finished goods were shipped from Puerto Rico to U.S. warehouses owned and operated by Charlie U.S. From the warehouses, they were distributed to other U.S. facilities owned by the parent, either for integration into other products, or sale to the unrelated U.S. and worldwide customers of the parent. Most of the products were sold within the United States.

In anticipation of the expiration of the possession tax credit, Charlie U.S. began preparing its “936 exit strategy.” It undertook a series of transfers and internal corporate restructurings that enabled it to preserve the tax savings that it had realized through its section 936 corporation.

Exit from possession corporation structure without toll charge

The Charlie group has completed its transfer of its Puerto Rican operations to a new Cayman subsidiary, Charlie Cayman, a DRE owned by Charlie Industries Mfg GmbH (Switzerland). The retained earnings of the possession corporation were now owned by the Swiss company. Product X continues to be manufactured in Puerto Rico and is shipped to U.S. warehouses and plants for distribution, but the ownership structure is that shown below:

Figure 14



On transfer of the Puerto Rican operations to Charlie Mfg GmbH, the parent valued the transferred assets at more than \$15 billion. Of that amount, almost all was attributed to residual intangible assets of foreign goodwill, going concern value, and workforce in place. On its tax return, Charlie Company did not recognize gain from disposition of those assets, claiming that gain from such residual assets are exempt from the requirement under section 367(d) that transfers of intangibles to foreign corporations in a reorganization must be recognized for tax purposes. Among the operations transferred were assets that had been acquired several years earlier for less than \$10 billion. According to independent valuation reports prepared for Charlie US for financial reporting and tax purposes at the time of that acquisition, less than \$100 million of the acquisition price was allocable to going concern value, workforce-in-place and goodwill of the Puerto Rican assets.

Intangibles exploitation and migration

Charlie Company financial statements report that goodwill and other intangible assets represent a third or more of its total assets. It attributed these assets to acquisitions. Over the years, the proportion of assets attributed to goodwill and other similar unidentified intangibles has grown. More than half of the goodwill reported is attributed to the Product X segment.

The intangible property developed by Charlie U.S. include both manufacturing intangibles, such as patents, and marketing intangibles, such as trademark rights held by parent, its distribution network, customer relationships, U.S. customer service response, tradeshow experience, and an experienced sales force. Historically, Charlie U.S. was compensated for use of its intangibles by Charlie PR through a royalty payment for use of its patents and trademarks, and a routine return for distribution and marketing services.

Transfer-pricing methodology

For the period prior to the study period, the compensation of Charlie U.S. was determined under the terms of a settlement with the IRS that covered (1) sales of Product X from Charlie PR to Charlie U.S., (2) the licensing of intangible property from Charlie U.S. to Charlie PR and (3) calculation of a section 936 cost-sharing payment from Charlie PR to the parent. Charlie represented to the IRS no significant marketing intangibles existed, and those that did were owned by Charlie PR. No extensive functional analysis was performed. The IRS accepted Charlie U.S. as the tested party for purposes of determining allocation of profits.

The transfer price for the sales of Product X was determined by a hybrid method, under which Charlie PR would first construct its sales income using a CUP, and then test it by use of a comparable profit method and profit/loss indicators determined by Berry ratios. For the licensed manufacturing intangibles, a CUT was accepted, supporting a royalty of approximately 6 percent of sales receipts, i.e., a routine return. All residual profits remained with Charlie PR. Finally, the settlement required section 936 cost-sharing payments by Charlie PR equal to its proportionate share of costs plus ten percent less royalties it paid to third parties, amortization of acquired intangibles and other expenses.

During the study period through the present, Charlie PR and its successor, Charlie Cayman, used a transfer-pricing methodology for sales of Product X to Charlie US substantially similar to the method described above.

Summary

Charlie Cayman is now the manufacturer of Product X. It sells the manufactured product to Charlie U.S. or its related party distributors. As a DRE, for U.S. tax purposes, all of the income, expense, taxes, and earnings and profits of Charlie Cayman are deemed attributable to Charlie Switzerland. There is very little subpart F income resulting from the operations of Charlie Switzerland and its DREs. The ability to defer recognition of the earnings of operations in Puerto Rico contributes to the company's offshore earnings, which are consistently reinvested in the offshore subsidiaries.

Charlie Switzerland sells the products produced at the manufacturing and assembly operations in Charlie Cayman to its U.S. customers, and retains all profits less compensation for use of the distribution network and royalties on any licensed manufacturing intangibles. This results in Charlie's low worldwide average tax rate and its significant tax-deferred earnings in a low-tax jurisdiction.

D. Delta Company

Overview of the company

Delta Corporation (“Delta”) is a publicly traded U.S. based multinational company that manufactures and markets technology-based consumer products, many of which are patent protected. For the study period, Delta had average annual global revenues of \$100 billion.¹⁹² Operations in the United States accounted for 45 to 55 percent of revenue.

For the study period, Delta’s average U.S. GAAP consolidated income (i.e., income reported to shareholders) before income taxes was approximately \$20 billion, of which approximately \$2 billion (or 10 percent) was attributable to U.S. operations and \$18 billion (or 90 percent) was attributable to foreign operations. The average total U.S. GAAP worldwide tax provision for the period was \$3 billion, including \$0.5 billion U.S. Federal and State tax expense and \$2.5 billion of foreign tax expense resulting in a worldwide average tax rate between 10 and 15 percent. This worldwide average tax rate included the benefit of having no U.S. residual tax accrued on foreign earnings that were in excess of \$80 billion for which the company has asserted permanent reinvestment offshore.

Delta employs many people worldwide. The operating activities of Delta’s employees include R&D activities, as well as manufacturing, marketing, sales, and distribution. For the study period, Delta’s average global R&D expense was approximately \$15 billion. Substantially all R&D was physically performed by employees in the United States. Certain foreign affiliates reimbursed Delta for some of the R&D expenses incurred in the later stages of product development; nevertheless, Delta bore a substantial portion of the overall development cost for each product.

Global tax structure

Delta and its domestic affiliates (collectively “Delta U.S.”) file a U.S. consolidated tax return. Delta operates globally through a variety of controlled foreign corporations CFCs, DREs, and foreign branches. Four entities are of primary importance to the generation of the bulk of Delta’s deferred foreign earnings. These entities are as follows:

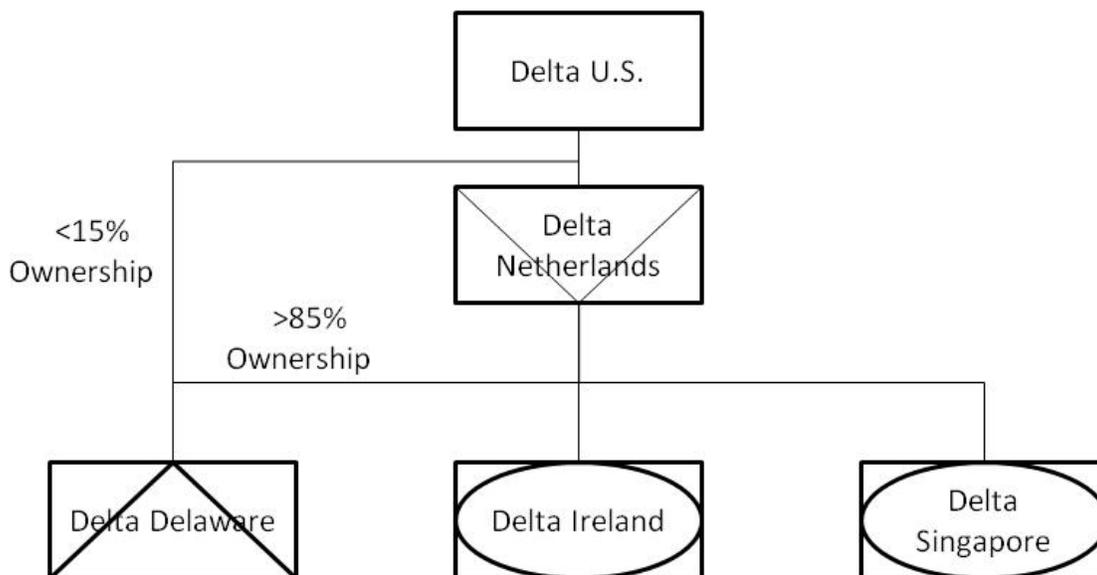
- Delta Netherlands CV (“Delta Netherlands”), a Dutch limited partnership, is a wholly owned CFC directly held by Delta U.S. Delta Netherlands is the principal holding company for Delta’s foreign manufacturing operations.
- Delta Delaware LLC (“Delta Delaware”), a Delaware limited liability company, is a partnership for U.S. tax purposes. It is an operating company that is the licensee of certain Delta intangible property. Delta Delaware manufactures products using that intangible property in Puerto Rico and sells the manufactured products to Delta U.S. and foreign affiliates for eventual sale to third parties.

¹⁹² This amount is presumed for purposes of presenting the case study.

- Delta Ireland Ltd. (“Delta Ireland”), an Ireland private limited company, is a DRE wholly owned by Delta Netherlands. It is an operating company that is the licensee of certain Delta intangible property. Delta Ireland manufactures products using that intangible property in Ireland and sells the manufactured products to Delta U.S. and foreign affiliates for eventual sale to third parties.
- Delta Singapore Pte. Ltd. (“Delta Singapore”), a Singapore private limited company, is a DRE wholly owned by Delta Netherlands. It is an operating company that is the licensee of certain Delta intangible property. Delta Singapore manufactures products using that intangible property in Singapore and sells the manufactured products to Delta U.S. and foreign affiliates for eventual sale to third parties.

Delta Ireland and Delta Singapore are DREs as a result of making check-the-box elections. This abbreviated tax structure is illustrated in Figure 15 below.

Figure 15



As Delta Ireland and Delta Singapore are DREs, for U.S. tax purposes Delta Netherlands is generally treated as performing all of the activities of Delta Ireland and Delta Singapore. However, the discussion that follows focuses on the actual functions performed by each DRE.

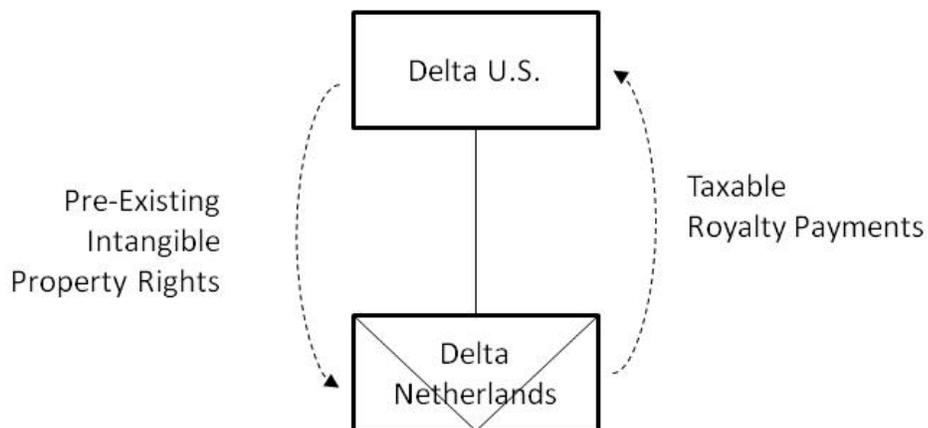
Ownership and exploitation of intangible property

Since its formation, Delta U.S. has assumed primary responsibility for product-related R&D, including the responsibility for bringing new and improved products to market and the risk that R&D may be unsuccessful. Consequently, Delta U.S. owns substantially all product-related intangible property (including patents, technical know-how, and trademarks). However, Delta U.S. has entered into numerous license agreements with Delta Netherlands, granting it

rights to exploit that intangible property throughout the world. These license agreements cover a wide variety of products, including many of the products that have become the greatest commercial successes for Delta.

In exchange for license rights with respect to a particular product, Delta Netherlands agrees to pay Delta U.S. royalties based on net sales of that product to third parties. During the study period, the royalties paid to Delta U.S. under these licenses averaged \$6 billion per year. The royalties are currently taxable to Delta U.S. in the United States. In addition, the royalties are currently deductible by the payor in its local jurisdiction (as described below, that may be the Netherlands, Ireland, or Singapore); however, any tax benefit from those deductions is realized at the local effective rate, which in each case is significantly lower than the U.S. rate. These license agreements are illustrated in Figure 16 below.

Figure 16



Generally, Delta U.S. does not license any product-related intangible property until the product is at least sufficiently developed that it is ready, or nearly ready, for sale to third parties. Nevertheless, some further R&D is typically performed before sales to third parties begin, and R&D continues after third-party sales have begun. Under the license agreements, Delta Netherlands agrees to reimburse Delta U.S. for any such additional R&D at cost (i.e., Delta Netherlands does not pay any markup). Any such reimbursement is taxable income in the United States but is directly offset by a deduction for the cost incurred by Delta U.S. in performing the R&D; thus, there is no net additional U.S. tax liability. The reimbursement is currently deductible by the payor in its local jurisdiction (as described below, that may be Puerto Rico, Ireland, or Singapore); however, any tax benefit from those deductions is realized at the local tax rate, which in each case is significantly lower than the U.S. rate. The cost of the additional R&D that is borne by Delta Netherlands represents a small proportion of Delta U.S.'s overall R&D expense. In a recent year, for example, Delta Netherlands's R&D expense equaled approximately one percent of Delta U.S.'s total R&D expense. However, by licensing the product-related intangible property to Delta Netherlands before all R&D is completed, Delta U.S. takes the position that the royalty rate should be lower than had the product-related intangible property been licensed at a time when no further R&D was required.

Delta has acquired various competitors. Historically, Delta and each of these competitors owned corporations in Puerto Rico that qualified for benefits under section 936. The benefits

that were available under section 936 are described in more detail above. Following the congressional decision to eliminate section 936 benefits, Delta restructured its Puerto Rico operations. As part of that restructuring, Delta Delaware was formed to own and operate the Puerto Rico manufacturing assets controlled by Delta, including those owned by its section 936 corporations.

Various domestic and foreign entities controlled by Delta transferred manufacturing plants and equipment and intangible property to Delta Delaware in exchange for partnership interests. Delta Netherlands made contributions of intangible property to Delta Delaware. In making these contributions, Delta Netherlands agreed to continue to be liable for the royalties owed to Delta U.S. under the licenses, but not for the further R&D required under the license agreements. At present, Delta Netherlands owns more than 85 percent of the interests in Delta Delaware. The remaining Delta Delaware interests are controlled by Delta U.S.

Similarly, Delta Netherlands has contributed other intangible property rights that it has licensed from Delta U.S. to Delta Ireland and Delta Singapore. Unlike the Delta Delaware contributions, however, Delta Netherlands has not agreed to continue to be liable for the royalties owed to Delta U.S. under the licenses. Instead, Delta Ireland and Delta Singapore are responsible for paying the royalties. Nevertheless, for U.S. tax purposes, Delta Netherlands is treated as paying the royalties since Delta Ireland and Delta Singapore are DREs. In addition, in each case, Delta Netherlands's manufacturing affiliate is responsible for reimbursing Delta U.S. for the cost of any additional R&D performed under the license agreements.

Delta's Puerto Rico manufacturing operations benefit from incentive grants, which partially exempt the operations from Puerto Rican taxes. Delta's Ireland and Singapore manufacturing operations benefit from incentive tax rates.

Value chain

Delta U.S. owns substantially all product-based intangible property, including all rights to exploit that property throughout the world. In a number of cases, Delta U.S. has licensed the U.S. and foreign intangible property rights to Delta Netherlands. Delta Netherlands has contributed these license rights to its manufacturing affiliates (Delta Delaware, Delta Ireland, and Delta Singapore). The manufacturing affiliates manufacture the products and sell them to Delta U.S. and foreign distribution affiliates.

Domestic

Delta U.S. is responsible for distribution and sale of finished products to third parties in the United States. Delta U.S. satisfies these responsibilities using its own employees. Delta U.S. bears most significant risks associated with the products, including: (1) discovery and development risk, including the responsibility for bringing new and improved products to market and the risk that R&D may not be successful; (2) marketing risk; (3) inventory risk in terms of performance and obsolescence; and (4) credit risk with respect to customer sales. The one area in which Delta U.S. does not bear risk is manufacturing risk throughout the manufacturing process, including risk related to time-to-market, product quality, and reliability. Delta Netherlands's manufacturing affiliates bear this risk.

To compensate Delta U.S. for the discovery and development risks it bears, it receives a royalty under the license agreements illustrated in figure 2 above. In the case of products for which patent protection has already expired at the time of the license, the royalty rate is typically one to five percent of net sales to third parties. In the case of products for which patent protection is still available at the time of the license, the royalty rate may range from 10 to 20 percent of net sales to third parties.

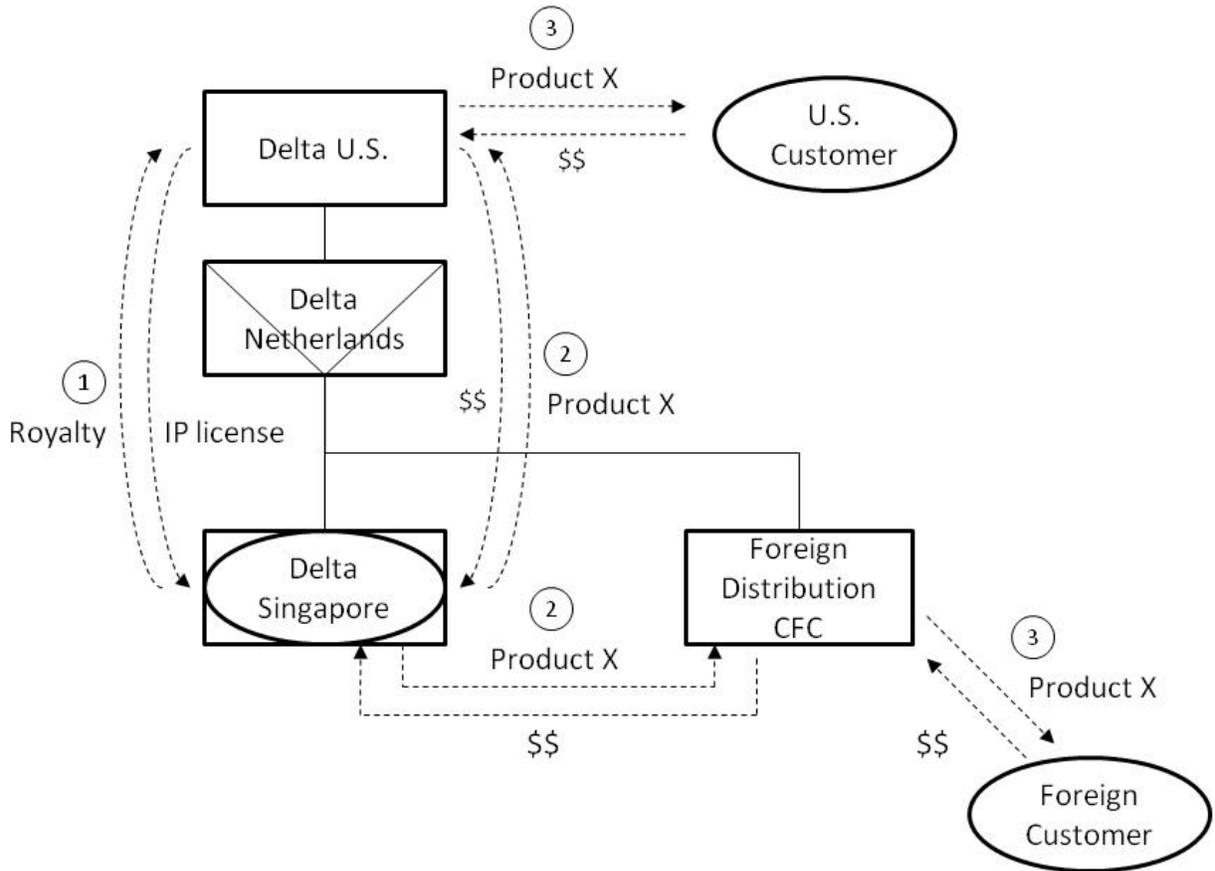
To compensate the U.S. group for the other risks it bears, Delta U.S. purchases finished products from Delta Netherlands's manufacturing affiliates at an amount equal to a percentage of the anticipated sales price to third parties. In the case of products for which patent protection has expired, Delta U.S.'s purchase price is typically 70 to 85 percent of the ultimate sales price to third parties; such a price provides Delta U.S. with a gross margin of 15 to 30 percent. In the case of products for which patent protection is still available, Delta U.S.'s purchase price may be between 40 and 50 percent of the ultimate sales price to third parties; such a price provides Delta U.S. with a gross margin of 50 to 60 percent. The different gross margins for patent-protected products and non-patent-protected products reflects the fact that marketing expenses are lower for the non-patent-protected products since customers are likely already familiar with those products by the time the patent protection expires.

Foreign

The foreign distribution affiliates are responsible for distribution and sale of the finished product to third parties outside the United States, including in Europe and Asia. The foreign distribution affiliates are typically CFCs organized by region and country that utilize their own employees to make sales. The foreign distribution affiliates bear many of the same risks as the U.S. group, including: (1) marketing risk; (2) inventory risk in terms of performance and obsolescence; and (3) credit risk with respect to customer sales. Like Delta U.S., therefore, the foreign distribution affiliates are compensated for these risks by purchasing finished products from Delta Netherlands's manufacturing affiliates at an amount equal to a percentage of the anticipated sales price to third parties. In the case of products for which patent protection has expired, the foreign distribution affiliate's purchase price is typically 70 to 85 percent of the ultimate sales price to third parties; such a price provides the foreign distribution affiliate with a gross margin of 15 to 30 percent. In the case of products for which patent protection is still available, the foreign distribution affiliate's purchase price may be between 40 and 50 percent of the ultimate sales price to third parties; such a price provides the foreign distribution affiliate with a gross margin of 50 to 60 percent. The different gross margins for patent-protected products and non-patent-protected products reflects the fact that marketing expenses are lower for the non-patent-protected products because customers are likely already familiar with those products by the time the patent protection expires.

Delta's value chain is illustrated in Figure 17 below.

Figure 17



In step 1 of Figure 17, Delta U.S. licenses product-related intangible property to Delta Singapore. Delta Singapore manufactures Product X and pays a royalty to Delta U.S. Step 2 illustrates the sale of Product X from Delta Singapore to Delta U.S. and a foreign distribution affiliate CFC. Step 3 illustrates the resale of Product X by Delta U.S. and the foreign distribution affiliate CFC to U.S. customers and foreign customers, respectively. An illustration involving a product manufactured by Delta Delaware or Delta Ireland would be similar, except that Delta Delaware or Delta Ireland, as the case may be, would be substituted for Delta Singapore in Figure 17.

The transactions illustrated in Figure 3 result in Delta U.S. recognizing income for U.S. tax purposes from two sources—the royalties received under the license agreement and the gross margin it earns on sales of Product X to third parties. However, Delta U.S. incurs two types of significant, currently deductible expenses that limit the net income on which Delta U.S. must pay U.S. tax. These expenses are for R&D, which likely relates to products other than Product X that are not yet ready for sale to third parties, and sales and marketing expenses incurred to make the third-party sales of Product X.

Delta U.S.'s foreign distribution affiliate CFC similarly recognizes income in its local jurisdiction from the gross margin it earns on sales of Product X to third parties, which is also substantially offset by the sales and marketing expenses it incurs in making the third-party sales.

Delta Singapore recognizes income for Singaporean tax purposes from the sale of Product X to Delta U.S. and the foreign distribution affiliate CFC. That income is offset by the royalty that Delta Singapore must pay to Delta U.S. as well as the other costs of manufacturing Product X. However, the other manufacturing costs generally are fairly low, which results in Delta Singapore earning a significant profit.

Summary

Delta U.S. invests substantial time and money in conducting R&D to discover and develop new products. Once a new product is sufficiently developed such that it is ready, or nearly ready, for sale to third parties, Delta U.S. often licenses the rights to exploit it to Delta Netherlands in exchange for a royalty based on the net sales of the product to third parties. Following licensing, Delta Netherlands bears the financial burden for some minimal level of further R&D conducted by Delta U.S., and this burden is cited to justify a lower royalty rate than if R&D for the product was fully complete prior to the license.

Delta U.S. has licensed many of what have proven to be its most commercially successful products in this way. By waiting to license product-related intangible property until the R&D process is substantially complete and the product is ready, or nearly ready, for sale to third parties, Delta U.S. ensures that virtually all R&D costs are incurred in the United States and deducted on its U.S. tax return. As a consequence, Delta U.S. minimizes the risk that it will incur substantial costs in connection with a noncommercially viable product in a foreign jurisdiction with a low effective tax rate. On the other hand, if the product is commercially successful, a substantial share of its income (net of royalty) will be earned in a foreign jurisdiction with a low effective tax rate.

Following the license, Delta Netherlands, or one of its manufacturing affiliates, manufactures the product and sells it to Delta U.S. and foreign distribution affiliates. Delta Netherlands, which bears only manufacturing risk, retains a substantial portion of the profit resulting from the product. The profits retained by Delta Netherlands are permanently reinvested in the Netherlands. The average Dutch tax rate on these earnings in the Netherlands has been approximately five percent over the study period.¹⁹³ Earnings for which Delta has asserted permanent reinvestment offshore—reflecting Delta’s expectation that they will never be subject to U.S. taxation—are now in excess of \$80 billion. Approximately 45 to 55 percent of Delta’s revenue is from U.S. operations, but an average of only 10 percent of its earnings before income taxes are reported as U.S. earnings.

¹⁹³ The tax rate was determined based on cash taxes paid as a percentage of the earnings and profits attributable to Delta Netherlands.

E. Echo Company

Overview of the company

Echo Company (“Echo”) is a publicly-traded U.S. based multinational company that manufactures technology-based consumer products, many of which are patent protected. Echo has many employees worldwide. It has manufacturing facilities in several countries including the United States, Puerto Rico, Switzerland, and Ireland.

For the study period, Echo had average global revenues of \$100 billion annually.¹⁹⁴ More than 60 percent of Echo’s sales were to customers in the United States and over 20 percent were to customers in Europe. For the study period, Echo reported average annual U.S. GAAP consolidated income before income taxes of \$25 billion. Although the percentage of sales to U.S. customers declined over the study period, from approximately two thirds of worldwide sales to approximately 60 percent, reported earnings before taxes attributable to U.S. operations declined significantly, from approximately 50 percent to approximately 25 percent of worldwide earnings over the study period.

Echo reported a worldwide average tax rate of approximately 20 percent for the study period. The company’s average tax expense over the study period was \$5 billion, \$4 billion of U.S. Federal and State taxes, and \$1 billion foreign taxes.

Echo reported unremitted earnings of subsidiaries outside the United States of nearly \$70 billion at the end of the study period. For financial statement purposes, no U.S. income taxes were accrued on those earnings as the company reports that its intention is to permanently reinvest the earnings overseas.

Global tax structure

Echo and its domestic affiliates (collectively “Echo U.S.”) file a consolidated tax return. Echo operates globally through CFCs, DREs, foreign branches, and partnerships. The majority of Echo’s U.S. tax deferred foreign earnings are generated through the following entities.

- Echo Holding Switzerland GmbH (“Echo Switzerland”) is a wholly owned CFC held indirectly by Echo U.S. through a Netherlands DRE. This CFC makes up the bulk of the company’s foreign income deferral. It has several DRE branches with manufacturing operations in Ireland, Puerto Rico, and Switzerland.
- Echo Cayman Islands Co. (“Echo Cayman Islands”) is a Cayman Islands DRE wholly owned directly by Echo Switzerland. This DRE is the primary manufacturer in Puerto Rico.
- Echo Europe SARL (“Echo Europe”) is a Swiss DRE wholly owned by Echo Switzerland. This DRE owns the intangible property related to the manufacture and

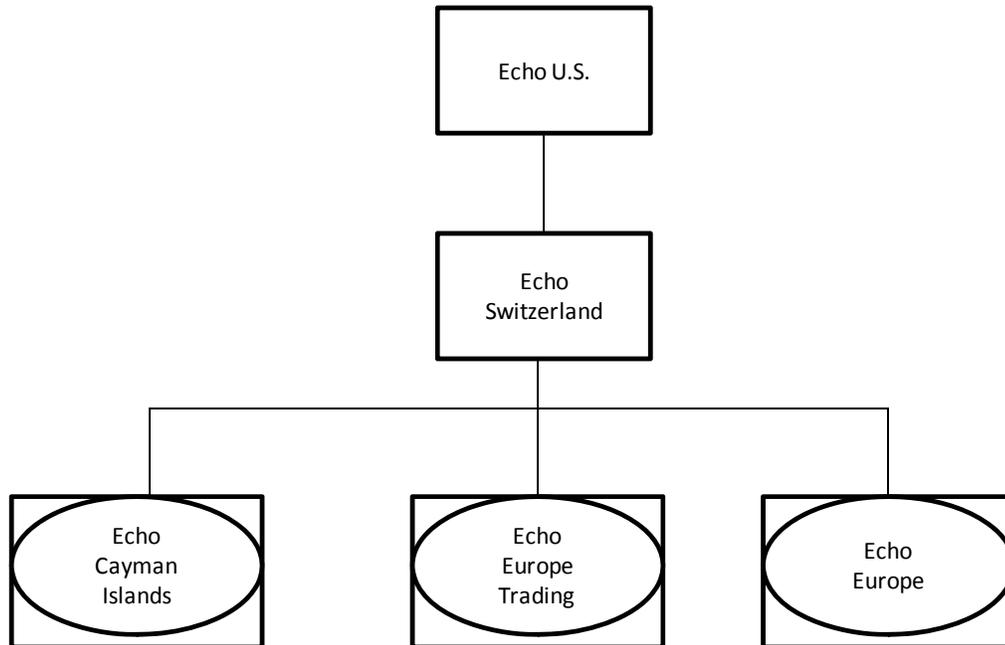
¹⁹⁴ This amount is presumed for purposes of presenting the case study.

distribution of certain products outside of the United States, and is the primary manufacturer in Switzerland.

- Echo Europe Trading SARL (“Echo Europe Trading”) is a Swiss DRE wholly owned by Echo Switzerland. This DRE acts as a commissionaire, distributing products manufactured by Echo Europe outside of the United States.

The abbreviated tax structure is illustrated in Figure 18 below.

Figure 18



Puerto Rico manufacturing

Historically, Echo organized its manufacturing facilities in Puerto Rico as separate section 936 corporations. These manufacturing operations consisted of final assembly of certain technology-based consumer products. With the repeal of section 936, Echo moved its Puerto Rico manufacturing operations to Echo Cayman Islands.

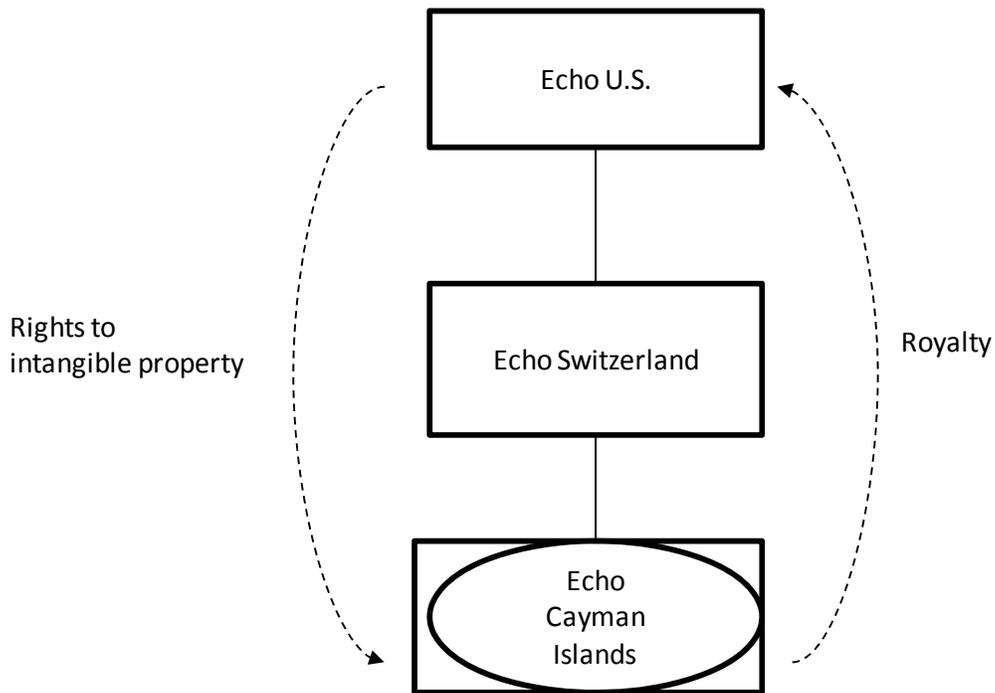
The exit strategy involved the formation of Echo Cayman Islands. Echo U.S. then entered into a license agreement with Echo Cayman Islands for intangible property associated with products manufactured in Puerto Rico in exchange for a royalty payment based on net sales. Substantially all of the operational assets of the 936 corporations were transferred to Echo Cayman Islands in exchange for stock in transactions qualifying as section 351 transactions. There was a transfer of a small amount of U.S. intangible property (primarily workforce in place) transferred to Echo Cayman Islands in connection with the transfer of the Puerto Rico manufacturing operations. In exchange for this intangible property, Echo Cayman Islands paid

Echo U.S. royalties of \$190 million, to be amortized over 20 years. These royalties are subject to current U.S. taxation in the year received.

Echo treats Echo Cayman Islands as a full-fledged manufacturer. Echo maintains that Echo Cayman Islands has the manufacturing know-how and the on-site skills required to operate sterile environment manufacturing in Puerto Rico. Additionally, Echo Cayman Islands has licensed, from Echo U.S., the intangible property necessary to manufacture and sell certain Echo products. Echo Cayman Islands purchases many of the component parts from Echo U.S., including valuable key high-tech components that are included in the finished technology-based consumer products. The purchased components are then assembled in Puerto Rico and resold to Echo U.S. for sale to U.S. customers. Only a small percentage of Echo's total employees are physically located in Puerto Rico.

With the exception of the small amount of intangible property transferred to Echo Cayman Islands with the Puerto Rico operations, Echo U.S. continues to own the balance of intangible property and know-how associated with the products manufactured in Puerto Rico by Echo Cayman Islands. The intangible property includes the developed inventions, secret processes, technical information, patents, trade secrets, copyrights, and regulatory approvals related to several different technology-based consumer product lines. Echo U.S. grants an exclusive license to Echo Cayman Islands to develop and use the intangible property for manufacturing of Product X for sale in the U.S. market. For Product X, the royalty rate is generally set at 30 percent for related party sales and 20 percent for sales to unrelated parties; however, these rates can be as high as 45 percent if necessary to achieve a targeted overall profit split between Echo U.S. and Echo Cayman Islands. Echo U.S. also licenses the exclusive rights to Echo Cayman Islands to develop and use the intangible property for the purpose of manufacturing Product Y for sale worldwide. In exchange for this license, Echo Cayman Islands pays a royalty rate of 15 percent of net sales when property is sold to related parties, and 10 percent for property sold to unrelated parties. For Product Y, the royalty rates can be as high as 25 percent if necessary to achieve a targeted overall profit split between Echo U.S. and Echo Cayman Islands. Echo Cayman Islands paid an average annual royalty of \$10 billion to Echo U.S. over the study period. The royalty rates were set using the comparable uncontrolled transaction method. The license agreement between Echo U.S. and Echo Cayman Islands is illustrated in Figure 19 below.

Figure 19



Echo U.S. sells component parts to Echo Cayman Islands and to other related parties including Echo Europe. Historically, these parts were sold to the Puerto Rico manufacturing companies at cost plus a markup. The prices for these parts are determined using the comparable profits method and for the high-tech parts the price includes a 17 percent markup on cost. Echo U.S. maintains that the licensing agreement between Echo U.S. and Echo Cayman Islands includes the licensing of patents and technology relating to these key component parts. However, these parts, containing highly complex technology, provide the most significant value to the finished products. The patents and know-how used in the manufacturing of these parts is retained in Echo U.S. where the parts are manufactured. During the study period, Echo U.S. received average annual payments for its component parts of \$3 billion. Over 90 percent of the product manufactured in Puerto Rico is sold to Echo U.S. for distribution in the U.S.

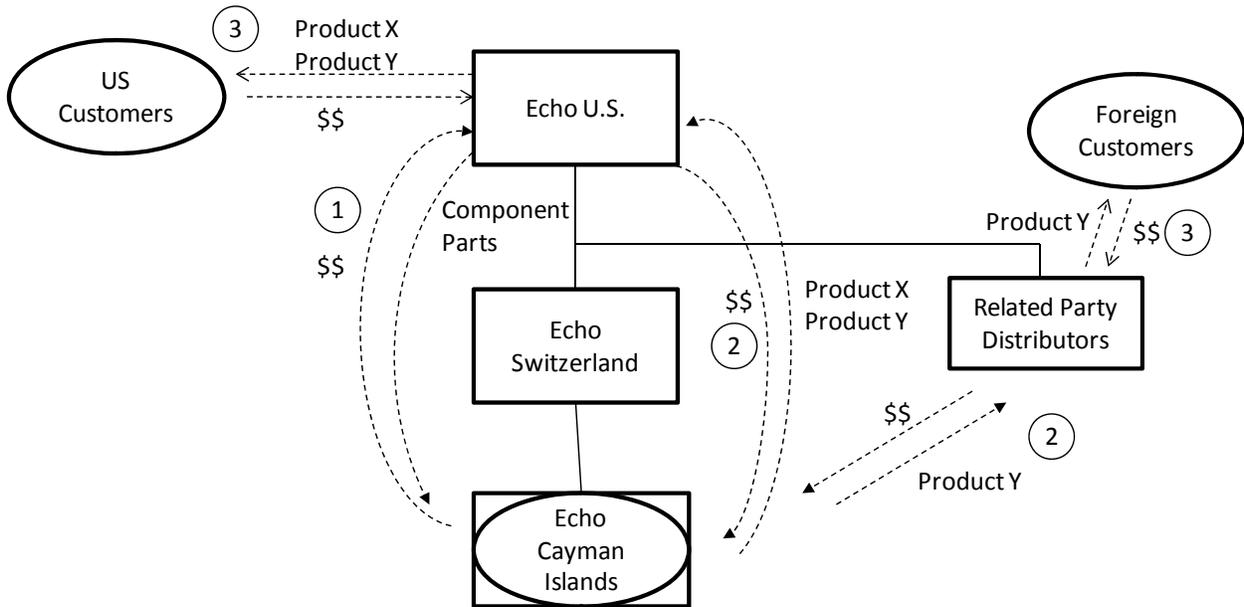
Echo Cayman Islands entered into a distribution agreement with Echo U.S., granting Echo U.S. the rights to market and distribute Product X in the United States, and for Product Y, granted Echo U.S. the worldwide rights for marketing and distribution. The price for selling the product to Echo U.S. for distribution in the United States is determined using the comparable uncontrolled transaction method with a comparable profit split method as a backup. Over the study period, Echo U.S. purchased products for an average annual amount of \$21 billion.

The transfer pricing studies for the various transactions (licensing of intangible property, purchase of component parts, and subsequent distribution by Echo U.S.) between Echo U.S. and Echo Cayman Islands were combined and an overall comparable profit split was determined

providing that Echo Cayman Islands should retain between 35 percent and 41 percent of the profit on Product X, and between 42 percent and 48 percent on Product Y.

The Puerto Rico manufacturing operations are shown in Figure 20 below.

Figure 20



Step 1 illustrates the sale of component parts from Echo U.S. to Echo Cayman Islands. Step 2 illustrates the sale of finished Product X and finished Product Y to Echo U.S., and the sale of Product Y to related party distributors for resale outside of the U.S. Step 3 illustrates the sale of Product X and Product Y by Echo U.S. to U.S. customers, and the sale of Product Y by related party distributors to foreign customers.

Echo U.S. owns intangible property related to Product X and Product Y. It manufactures the key components of the products, and sells the finished products in the U.S. market. Echo U.S. recognizes income for U.S. tax purposes from three sources - the gross margin it earns on the sale of Product X and Product Y to U.S. customers, the gross margin it earns on the sale of component parts to Echo Cayman Islands, and the license fee income it receives from Echo Cayman Islands for the intangible property rights related to the manufacture of Product X and Product Y. Echo U.S. incurs two types of currently deductible expenses that reduce U.S. taxable income in connection with these transactions. These expenses include sales and marketing expenses incurred to make the sales to U.S. customers and R&D costs. Additionally, Echo U.S. may qualify for a U.S. income tax credit for some or all of its R&D costs.

Echo Cayman Islands licenses the intangible rights to make and distribute Product X in the United States and to make and distribute Product Y worldwide. It purchases key components and manufactures the finished products in Puerto Rico. Echo Cayman Islands recognizes income on profits from its sales of product to Echo U.S. and to related party foreign distributors. This income is reduced by the license fees and commissions paid to Echo U.S.

The average annual net income before tax retained at Echo Cayman Islands was \$8 billion during the study period on an average of \$23 billion in sales.

Ownership and exploitation of intangible property

The worldwide rights to manufacture and distribute Product Y are owned by Echo U.S. and licensed to Echo Cayman Islands as previously discussed. The rights to manufacture and distribute Product X outside of the United States are discussed below.

Echo Europe is a manufacturing DRE wholly owned by Echo Switzerland. Echo Europe manufactures Product X in Switzerland for distribution in markets outside of the United States.

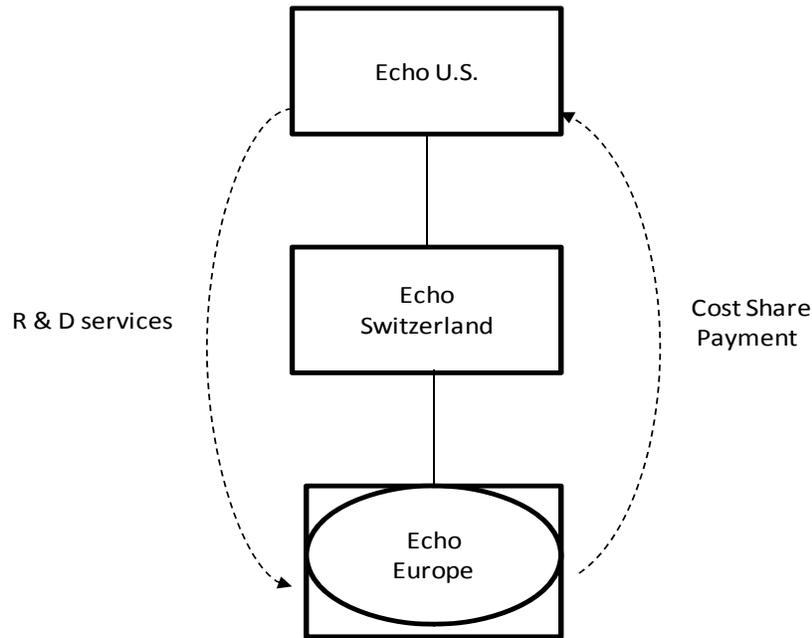
Echo Europe entered into a cost-sharing agreement with Echo U.S. to purchase and develop Product X outside of the United States. To allow Echo Europe to use pre-existing intangibles related to the cost-sharing agreement products, Echo Europe made a buy-in payment to Echo U.S. in the form of a royalty payment over a specified time period pursuant to a license agreement. The time-period specified was product dependent, but did not exceed ten years.

An initial payment of \$95 million was made by Echo Europe to be applied against the first year royalty payments. Royalty rates are determined for each product and range from 15 percent to 24 percent for products sold to related parties, and from 10 percent to 16 percent for products sold to unrelated parties. The cost-sharing agreement between the parties provides that allocable R&D costs are allocated based on the relative gross revenues to the total gross revenues from the specific products covered by the cost-sharing and buy-in agreements.

The royalty and cost-sharing payments are taxable in the United States and deductible payments for Echo Europe. The cost-sharing payment made to Echo U.S. averaged \$930 million annually over the study period. Over the study period, Echo Europe made royalty payments to Echo U.S. averaging \$860 million per year.

The Echo Europe cost-sharing arrangement is illustrated in Figure 21 below.

Figure 21

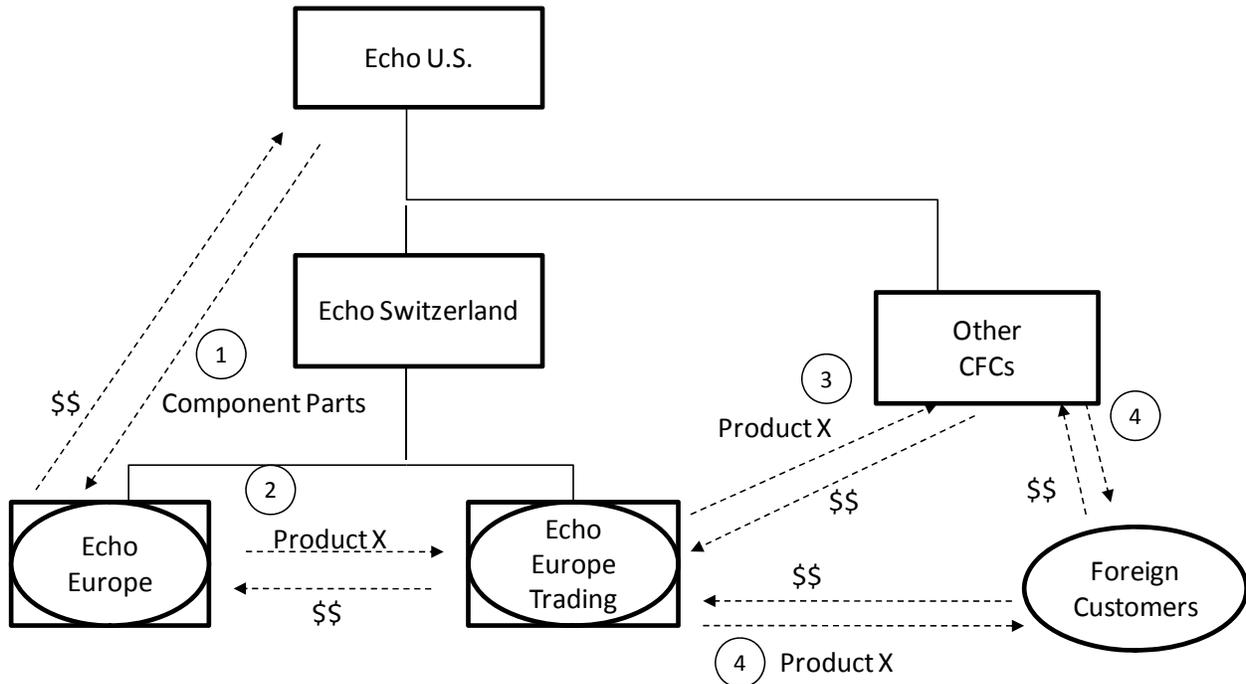


As in the case of the Puerto Rico manufacturing operations, Echo Europe purchases key component parts from Echo U.S. for use in the manufacture of Product X. Echo Europe's purchases from Echo U.S. averaged \$1.6 billion annually over the study period.

Echo Europe's sales over the study period averaged \$9 billion, with net income before taxes averaging \$4.5 billion over the same period. The majority of Echo Europe's sales are made to Echo Europe Trading, a commissionaire DRE. In return, Echo Europe Trading earns a return of two percent of sales. Echo Europe Trading averaged annual earnings before income taxes of \$300 million annually over the study period.

The sales component parts to Echo Europe, and the subsequent sale of Product X is illustrated in Figure 22 below.

Figure 22



Step 1 of figure 22 illustrates the sale of component parts by Echo U.S. to Echo Europe for use in manufacturing Product X. Step 2 illustrates the sale of Product X by Echo Europe primarily to Echo Europe Trading. Step 3 illustrates the sale of Product X by Echo Europe Trading to other distribution CFCs. Step 4 illustrates the sale of Product X by Echo Europe Trading and the distribution CFCs to foreign customers.

Echo U.S. owns intangible property related to Product X. It manufactures the key components of the products for sale to Echo Europe to use in the manufacture of Product X. Echo U.S. recognizes income for U.S. tax purposes from the transactions with Echo Europe from three sources - the gross margin it earns on the sale of component parts to Echo Europe, the license fee income it receives from Echo Europe for the buy-in agreement, and the annual cost-share payments from the cost-sharing agreement with Echo Europe. Echo U.S. incurs R&D expenses in connection with these transactions. Additionally, Echo U.S. may qualify for a U.S. income tax credit for some or all of its R&D costs.

Echo Europe also owns the intangible rights to make and distribute Product X outside the United States. It purchases key components and manufactures the finished products in Switzerland. Echo Europe recognizes income on profits from its sales of product to Echo Europe Trading. This income is reduced by the license fee paid to Echo U.S. for the buy-in payment and by the annual cost-share payments.

Summary

Echo Cayman Islands, Echo Europe, and Echo Europe Trading are check-the-box DRE's that are treated for U.S. tax purposes as branches of Echo Switzerland. For U.S. tax purposes, all of the income, expense, taxes, and earnings and profits are deemed attributable to Echo

Switzerland. Echo Switzerland reported average annual sales of \$50 billion and earnings before taxes of \$15 billion annually over the study period. It paid average annual taxes of \$350 million annually (primarily in Switzerland, Puerto Rico, and the Cayman Islands) for an average tax rate of approximately two percent.

Echo Cayman Islands and Echo Europe are the manufacturers of product and, in the case of Echo Europe, the owner of the manufacturing intangibles. These DREs sell the manufactured product either to Echo U.S. or to related party commissionaires and distributors. There is very little subpart F income resulting from the operations of Echo Switzerland and its DREs (an average of \$1.7 billion annually). At the end of the study period, Echo Switzerland had accumulated earnings and profits of \$60 billion.

Average annual payments includible in the U.S. taxable income of Echo U.S. (inclusive of those discussed above) included \$8 billion for the purchase of component parts, \$1.6 billion in cost-sharing and other compensation, and \$11 billion in royalties.

Echo Switzerland, through its use of the manufacturing entities, primarily the operations between Echo Cayman Islands and Echo U.S., is able to retain a significant portion of profit from sales to U.S. customers. This results in Echo's low worldwide average tax rate and its significant tax-deferred earnings in low-tax jurisdictions.

F. Foxtrot Company

Overview of the company

Foxtrot, Inc. (“Foxtrot”) is a publicly traded U.S. based multinational company that designs, manufactures, and markets a broad variety of consumer products worldwide. The company’s products are sold throughout the world but its largest market is the United States which accounts for approximately 50 percent for the company’s sales. This includes sales to the company’s three largest customers, all U.S. retail chain stores, which account for approximately 40 percent of worldwide consolidated net sales. The rest of Foxtrot’s sales are to significant foreign markets in Europe, Latin America and the Asia Pacific. While most domestic sales and international sales are made directly to third-party retailers and wholesalers, some international sales are made through third-party agents and third-party distributors in countries where Foxtrot has no local presence.

For the study period, Foxtrot had average global revenues of \$100 billion.¹⁹⁵ For the same period, Foxtrot’s average U.S. GAAP consolidated income (i.e., income reported to shareholders) before income taxes was \$10 billion, of which \$200 million was attributable to U.S. operations and \$9.8 billion was attributable to foreign operations. Accordingly, although approximately 50 percent of sales for the study period were to U.S. customers, two percent of U.S. GAAP consolidated income before income taxes was attributable to U.S. operations.¹⁹⁶ The average total U.S. GAAP worldwide income tax expense for the period was \$1.6 billion, including approximately \$100 million of U.S. Federal and state tax income benefit¹⁹⁷ and \$1.7 billion of foreign income tax expense, resulting in a worldwide average income tax rate of approximately 16 percent. Foxtrot does not include in its worldwide income tax expense or its worldwide average income tax rate any tax on accumulated foreign earnings that were in excess of \$50 billion because these are earnings for which the company has asserted permanent reinvestment.

Foxtrot employs many people worldwide. Foxtrot’s employees primarily engage in R&D activities such as product development and design, and other activities including manufacturing, advertising, marketing and distribution. For the study period, Foxtrot’s average global R&D expense was approximately \$3 billion. Although R&D is funded by both Foxtrot’s U.S. and foreign operations, substantially all of Foxtrot’s R&D activities were performed by its U.S. employees located within the United States. Foxtrot’s manufacturing of all of its major products is performed by employees at the company’s primary manufacturing facilities in Asia and Latin America; however, the company uses third-party manufacturers in the United States and elsewhere for the manufacturing of other products considered to be of lesser importance.

¹⁹⁵ This amount is presumed for purposes of presenting the case study.

¹⁹⁶ Although domestic operating losses were a significant contributor to the relatively small percentage of U.S. consolidated income before income taxes as compared to total consolidated income before income taxes for the study period, this percentage did not materially increase for years outside of this study period where domestic operating losses may not have been as much of a factor.

¹⁹⁷ This benefit relates to Foxtrot U.S. being in a U.S. net operating loss position for the study period.

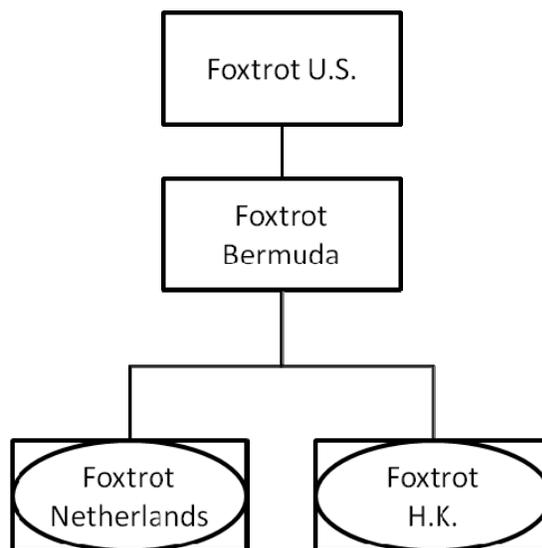
Global tax structure

Foxtrot and its domestic affiliates (collectively “Foxtrot U.S.”) file a U.S. consolidated income tax return. Foxtrot operates globally through CFCs, foreign DREs, and foreign branches; however, transactions among these three entities generate a significant portion of Foxtrot’s U.S. tax deferred foreign earnings:

- Foxtrot Bermuda Inc. (“Foxtrot Bermuda”) is a wholly owned CFC indirectly held by Foxtrot U.S. It is the economic owner and the licensor of the foreign rights to certain Foxtrot intangible property
- Foxtrot Netherlands B.V. (“Foxtrot Netherlands”) is a Netherlands DRE wholly owned by Foxtrot Bermuda. It is an operating company that licenses the foreign rights to the intangible property held by Foxtrot Bermuda and serves as the principal with responsibility for the manufacture (through a related party contract manufacturer), marketing, sale and distribution of certain Foxtrot products. It has over 70 employees that are primarily responsible for logistics, warehousing, and providing administrative support to other Foxtrot European affiliates.
- Foxtrot Hong Kong Limited (“Foxtrot H.K.”) is a Hong Kong DRE wholly owned by Foxtrot Bermuda. It serves as a contract manufacturer on behalf of Foxtrot Netherlands in addition to engaging in certain sourcing and procurement related activities on behalf of the Foxtrot group. While Foxtrot Netherlands works with other Foxtrot owned foreign contract manufacturers, the contract manufacturing activities of Foxtrot H.K. are the greatest by volume and present a fair representation of those activities performed by other Foxtrot foreign contract manufacturers.

Foxtrot Netherlands and Foxtrot H.K. are treated as corporations for foreign tax purposes but are treated as DREs as a result of check-the-box elections. This abbreviated tax structure is illustrated in Figure 23 below.

Figure 23



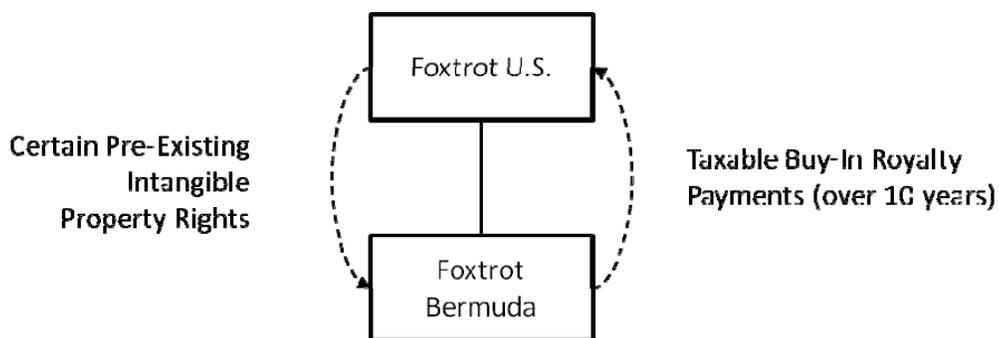
As Foxtrot Netherlands and Foxtrot H.K. are DREs, for U.S. tax purposes Foxtrot Bermuda is generally treated as performing all of the activities of Foxtrot Netherlands and Foxtrot H. K. However, the discussion that follows focuses on the functions actually performed by each DRE.

Ownership & exploitation of intangible property

In the mid-1990s, Foxtrot decided to have Foxtrot Bermuda assume primary responsibility for the manufacture, sale, marketing, and distribution of certain existing and newly-developed Foxtrot products outside the United States, while Foxtrot U.S. retained primary responsibility for the manufacture and sale of all Foxtrot products within the United States. Consequently, Foxtrot U.S. entered into a licensing (“buy-in”) agreement and cost sharing agreement with Foxtrot Bermuda with respect to the economic (i.e., tax) ownership¹⁹⁸ of the foreign rights to the intangible property related to certain Foxtrot product lines (hereinafter the “foreign intangible property rights” or “foreign rights”).¹⁹⁹

To allow Foxtrot Bermuda to use the pre-existing intangibles made available through the cost sharing agreement, Foxtrot Bermuda paid a buy-in royalty to Foxtrot U.S., the amount of which was determined using an unspecified method. This methodology resulted in Foxtrot Bermuda making a declining royalty payment to Foxtrot U.S. over a 10-year period. Total royalty payments made by Foxtrot Bermuda to Foxtrot U.S. over the 10-year period were approximately \$5 billion. These royalties were taxable in the United States upon inclusion. As there is no corporate income tax in Bermuda, the corresponding royalty expense at Foxtrot Bermuda did not create a tax deduction. The Foxtrot Bermuda buy-in payment is illustrated in Figure 24 below.

Figure 24

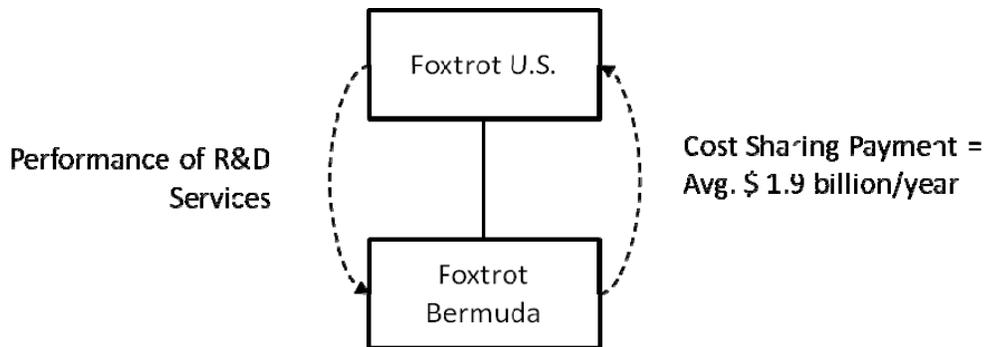


¹⁹⁸ Although economic ownership was transferred to Foxtrot Bermuda, legal ownership of all intangible property has remained in the United States for all Foxtrot products.

¹⁹⁹ According to the licensing and cost sharing agreements, the pre-existing intangible property rights covered and subject to future cost sharing included all intangible property rights and associated intangible property rights (including patents, copyrights, trade secrets, trademarks, manufacturing processes and know how or other proprietary rights) owned or otherwise held by Foxtrot as of a specific date, including property being developed but not yet completed on that date.

Under the cost sharing agreement, Foxtrot U.S. and Foxtrot Bermuda cost share the R&D performed by the Foxtrot group based on each company's sales as a percentage of total Foxtrot sales. The percentage of costs borne by each is revised annually to update the percentage of total R&D expenditures for which Foxtrot U.S. and Foxtrot Bermuda are responsible in accordance with the Treasury regulations on cost sharing. On average, 90 percent of the R&D performed by Foxtrot is subject to cost sharing. Of the amount cost shared, between 40 and 45 percent are costs borne by Foxtrot Bermuda. As mentioned above, substantially all of the R&D related activity is performed in the United States by employees of Foxtrot U.S. As a result, Foxtrot Bermuda reimburses Foxtrot U.S. for R&D performed on Foxtrot Bermuda's behalf. For the study period, Foxtrot Bermuda's average annual cost-sharing payment to Foxtrot U.S. was \$1.9 billion. These annual cost sharing payments are taxable income in the United States such that they offset the benefit of any U.S. R&D expense deduction. Nonetheless, Foxtrot U.S. may be eligible for an R&D tax credit even for those expenditures reimbursed by Foxtrot Bermuda under the cost sharing agreement. Given the lack of a corporate income tax in Bermuda, the shifting of this deduction to Bermuda does not provide any corresponding foreign tax benefit. Figure 25 below depicts the payment made by Foxtrot Bermuda to Foxtrot U.S. for the performance of contract R&D under the cost sharing agreement.

Figure 25



Foxtrot Bermuda's buy-in payment with respect to the pre-existing intangibles previously acquired or developed by Foxtrot U.S. and its continued funding of its ratable share of the R&D performed by Foxtrot U.S. employees generally entitles Foxtrot Bermuda to all of the future profit (income in excess of the annual cost sharing payment) attributable to the product lines that it cost shares. Conversely, Foxtrot Bermuda also bears the risk and the cost of any future losses.

Domestic value chain

In connection with the ownership of the U.S. rights to exploit the intangible property, Foxtrot U.S. is responsible for the manufacture, sale, marketing and distribution of all related products within the United States.²⁰⁰ While Foxtrot U.S. does some limited manufacturing within the United States and is entitled to any associated manufacturing income therefrom, Foxtrot U.S. has permitted Foxtrot Netherlands to perform manufacturing on behalf of Foxtrot U.S. with respect to certain products to be sold within the United States. Although Foxtrot Netherlands has primary responsibility and bears all risks in connection with the manufacturing of these products, it engages Foxtrot H.K. (and to a lesser extent other foreign DRE affiliates) to serve as a contract manufacturer.

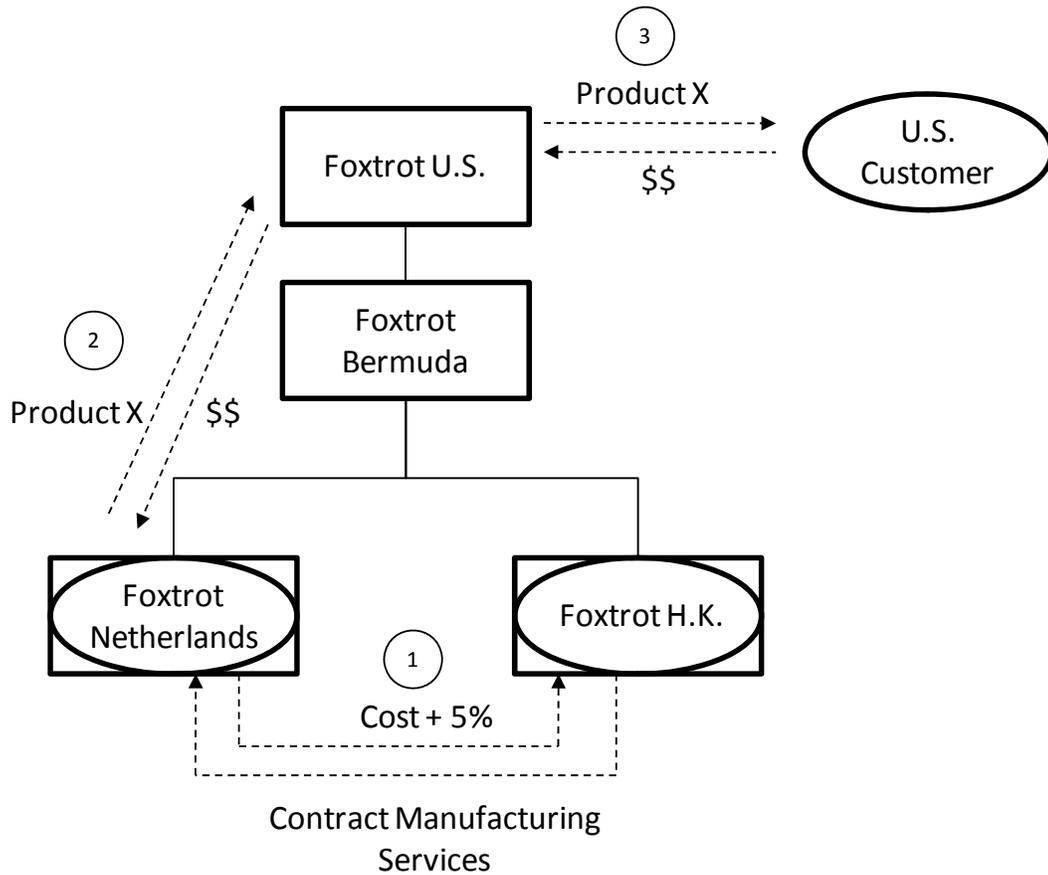
Under the contract manufacturing agreement, Foxtrot Netherlands purchases the raw materials used to manufacture the underlying products and provides them to Foxtrot H.K. on a consignment basis (i.e., Foxtrot Netherlands continues to hold title to the raw materials at all times). The services performed by Foxtrot H.K. on behalf of Foxtrot Netherlands under the agreement, include: (1) manufacturing and reworking products in accordance with contract specifications; (2) acting as Foxtrot Netherlands's agent in the procurement of materials to be used in such manufacturing and reworking operations; (3) providing general accounting and bookkeeping services related to the manufacture of products as well as procurement and subsequent integration of materials used in the manufacture and rework of the products; and (4) providing such other services related to the manufacture of products as Foxtrot Netherlands may reasonably request from time to time. Foxtrot H.K., through manufacturing facilities in multiple locations in Asia, manufactures the underlying products for a fee equal to direct and indirect costs incurred plus five percent. The five-percent markup constitutes taxable income to Foxtrot H.K. in the various jurisdictions in which its manufacturing facilities are located.

Foxtrot Netherlands sells the manufactured products to Foxtrot U.S. Hence, Foxtrot Netherlands is entitled to any resulting income to the extent of the excess of the sales price of these products over those costs incurred attributable to the contract manufacturing payment made to Foxtrot H.K. Such income is taxable in the Netherlands at a 25.5-percent tax rate after taking into account other appropriate deductions. Foxtrot U.S. then resells the product to third-party customers. The transfer price on these products has been set in a manner intended to provide Foxtrot U.S. with an arm's-length return that reflects that Foxtrot U.S. owns the U.S. rights to the intangible property, performs certain overhead related activities in connection with the sale of these products, and serves as the distributor of these products. As a result, to the extent the Foxtrot U.S.-owned brand names and goodwill generate additional income on sales to U.S. customers, Foxtrot U.S. is entitled to that income which will be taxable within the United States.

The Foxtrot U.S. domestic value chain is illustrated in Figure 26 below.

²⁰⁰ Although the Foxtrot U.S. entity that owns the intangible property is different than the Foxtrot U.S. entities that are responsible for the manufacture and distribution of the products attributable to the intangible property, all are members of the Foxtrot U.S. tax consolidated group and any intercompany royalties are eliminated in for U.S. Federal tax purposes.

Figure 26



In step 1 of Figure 26, Foxtrot Netherlands engages Foxtrot H.K. to perform contract manufacturing services in connection with the manufacture of Product X. Step 2 illustrates the sale of Product X from Foxtrot Netherlands to Foxtrot U.S. From a U.S. tax perspective, Steps 1 and 2 are treated as performed by Foxtrot Bermuda. Step 3 illustrates the resale of Product X by Foxtrot U.S. to its third-party retail store customers.

For the study period, Foxtrot U.S. reported average domestic gross receipts on its consolidated return of approximately \$46 billion and cost of goods sold of approximately \$29 billion (including \$26 billion attributable to purchases from Foxtrot Netherlands as discussed further below).²⁰¹ As a result of being in a significant domestic net operating loss position,

²⁰¹ The primary difference between the Foxtrot global revenue of \$100 billion and the Foxtrot U.S. gross receipts of \$46 billion is attributable to the fact that Foxtrot global revenues reflect sales made by Foxtrot U.S. as well as the Foxtrot foreign affiliates to third parties with appropriate intercompany eliminations. In contrast, the gross receipts of Foxtrot U.S. only reflect sales made by Foxtrot U.S. whether to third parties or foreign affiliates.

Foxtrot U.S. had very little U.S. taxable income for the study period even before applying net operating loss carryovers and had no U.S. tax liability for the period.

Foreign value chain

In connection with the foreign rights to the intangible property owned by Foxtrot Bermuda, Foxtrot Netherlands is responsible for the manufacture, sale, marketing, distribution as well as any sublicense of all related products outside of the United States. In return for use of the foreign intangible property rights, Foxtrot Netherlands compensates Foxtrot Bermuda through a royalty. The amount of the royalty paid by Foxtrot Netherlands to Foxtrot Bermuda is computed annually under a formula provided for in an advanced pricing agreement (“APA”) that Foxtrot Netherlands entered into with the Dutch tax authorities. The Dutch APA guarantees that Foxtrot Netherlands has a certain level of taxable income with respect to the principal activities it performs. For the study period, the average annual royalty was approximately \$4.6 billion. The net amount of taxable income in the Netherlands taking into account the royalty and other deductible expenses is subject to tax at a 25.5-percent tax rate. Upon receipt in Bermuda, this royalty income is not subject to any additional taxation given the lack of a corporate level income tax in Bermuda. Since Foxtrot Netherlands is a DRE under Foxtrot Bermuda, the entire royalty payment is disregarded for U.S. tax purposes and, therefore, not treated as a deemed dividend under the subpart F foreign personal holding company income rules.

As with the products manufactured on behalf of Foxtrot U.S., Foxtrot Netherlands has primary responsibility for the manufacturing of these products but engages Foxtrot H.K. (and to a lesser extent other foreign DRE affiliates) to serve as a contract manufacturer. Under the contract manufacturing agreement, Foxtrot Netherlands purchases the raw materials used to produce the underlying products and provides them to Foxtrot H.K. on a consignment basis. The specific services provided by Foxtrot H.K. to Foxtrot Netherlands under the contract manufacturing agreement are discussed under “Domestic Value Chain,” above. Foxtrot H.K., through manufacturing facilities in multiple locations in Asia, manufactures the underlying products for a fee equal to direct and indirect costs plus five percent. As part of this arrangement, Foxtrot Netherlands also bears the full cost of employment of the general manager of Foxtrot H.K. as if the general manager were Foxtrot Netherlands’s own employee.²⁰² This general manager is responsible for the day to day oversight of the contract manufacturing activities performed by Foxtrot H.K. The five-percent markup constitutes taxable income to Foxtrot H.K. in the various jurisdictions in which its manufacturing facilities are located. As Foxtrot Netherlands and Foxtrot H.K. are both DREs under Foxtrot Bermuda, the contract manufacturing arrangement between the two entities is generally disregarded except as discussed further below.

Once the products are manufactured, Foxtrot Netherlands then sells its products to unrelated customers through wholly owned CFC distributors of the Foxtrot group. Hence, Foxtrot Netherlands is entitled to any resulting income to the extent of the excess of the sales

²⁰² Foxtrot has asserted this general manager would be directly employed by Foxtrot Netherlands were it not for the taxable presence issues such direct employment could create for Foxtrot Netherlands in Hong Kong and the other locations in which Foxtrot H.K. operates.

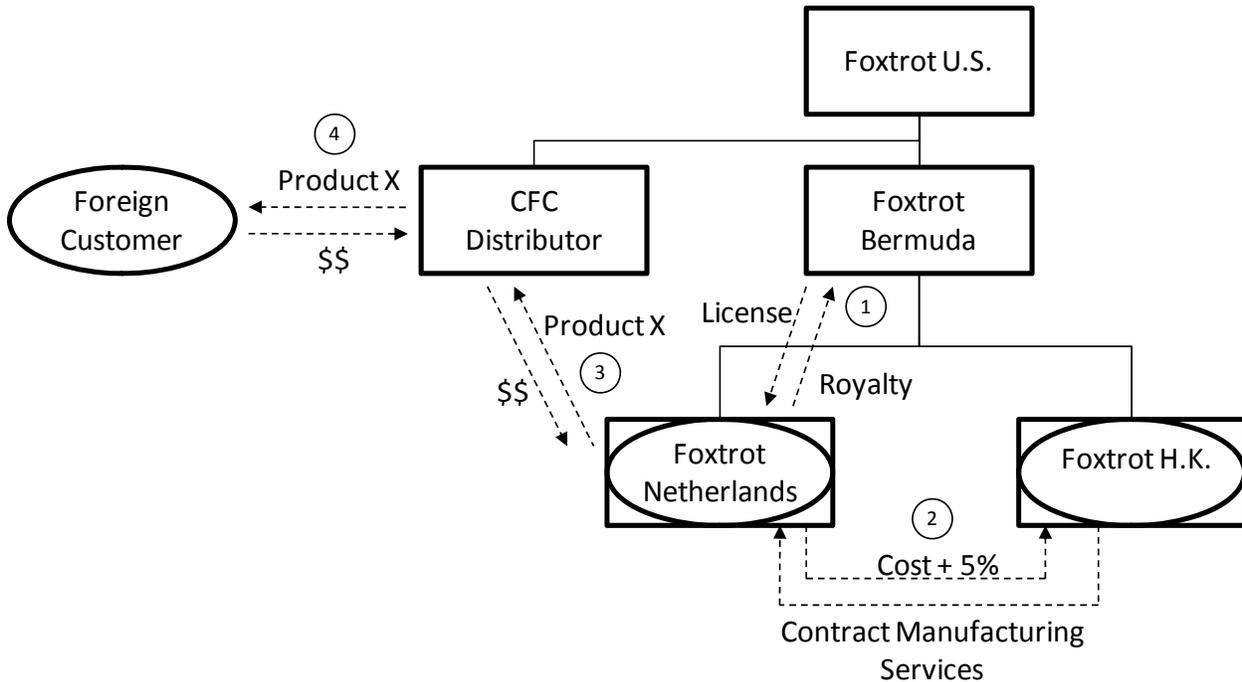
price of these products on its sales to the CFC distributors over those costs incurred attributable to: (1) the contract manufacturing fee paid to Foxtrot H.K.; and (2) the royalty payment made to Foxtrot Bermuda. Such income is subject to Dutch taxation. These CFC distributors are owned indirectly by Foxtrot U.S. and are located in countries that resell the underlying products to third-party customers. While some of the CFC distributors take on entrepreneurial risk and responsibilities and are accordingly entitled to a distribution margin that reflects these risks and responsibilities, other CFCs serve as limited-risk distributors and are only entitled to a smaller guaranteed return more akin to that of a service provider.

From a U.S. tax perspective, Foxtrot has historically maintained that Foxtrot Netherlands's distribution activities do not generate subpart F foreign base company sales income. Specifically, in connection with Foxtrot Netherlands related party sales through the Foxtrot CFC distributors, the company has maintained on these sales that Foxtrot Netherlands is a manufacturer as to the products manufactured with the assistance Foxtrot H.K. and is, therefore, eligible for the manufacturing exception to subpart F foreign base company sales income. Essential to this position is that Foxtrot Netherlands asserts that the Foxtrot H.K. general manager is in substance a Foxtrot Netherlands employee such that the activities that this general manager performs allow Foxtrot Netherlands to meet the manufacturing exception.

As noted above, in addition to holding the foreign rights to the Foxtrot intangible property, Foxtrot Bermuda serves as the holding company for Foxtrot Netherlands and Foxtrot H.K. Since each of these entities are generally disregarded as separate from Foxtrot Bermuda from a U.S. tax perspective, all of their operating activities and tax attributes flow up to Foxtrot Bermuda. For the study period, Foxtrot Bermuda reported average gross receipts of approximately \$58 billion, average current year E&P of approximately \$5 billion, and average current year cash taxes paid of \$500 million collectively representing its own activities as well as that of Foxtrot Netherlands and Foxtrot H.K. Foxtrot Bermuda has approximately \$20 billion of accumulated non-previously taxed earnings and profits.

The Foxtrot foreign value chain is illustrated in Figure 27 below.

Figure 27



In step 1 of Figure 27, Foxtrot Bermuda licenses the foreign intangible property rights to Foxtrot Netherlands. In Step 2, Foxtrot Netherlands engages Foxtrot H.K. to perform contract manufacturing services in connection with the manufacture of Product X. Step 3 illustrates the sale of Product X from Foxtrot Netherlands to a Foxtrot CFC Distributor. Step 4 illustrates the resale of Product X by the CFC Distributor to its 3rd party retail customers.

Summary

As a result of Foxtrot Netherlands acting as the principal with respect to products manufactured on its behalf by Foxtrot H.K., a related contract manufacturer, most of the foreign manufacturing income (i.e., amounts in excess of the contract manufacturing fee paid to Foxtrot H.K.) on these products accrues to Foxtrot Netherlands. Foxtrot Netherlands’s manufacturing income is then further increased as a result of the more limited role it serves as the manufacturer on those product lines attributable to U.S.-owned intangible property. While the taxable income of Foxtrot Netherlands is subject to tax in the Netherlands at a 25.5-percent tax rate, the Dutch tax base is substantially reduced as a result of the annual royalty paid by Foxtrot Netherlands to Foxtrot Bermuda for use of the foreign intangible property rights owned by Foxtrot Bermuda. This annual royalty is calculated under an advanced pricing agreement issued to Foxtrot Netherlands by the Dutch tax authorities which ensures Foxtrot Netherlands has a relatively small Dutch tax base. As a result of Foxtrot Bermuda making taxable cost sharing payments to Foxtrot U.S. with respect to R&D performed by Foxtrot U.S. employees, Foxtrot Bermuda’s

ownership of the foreign intangible property rights entitle it to retain the majority of these profits offshore where they are not subject to any Bermuda corporate level tax and are permanently reinvested. Earnings for which Foxtrot has now asserted permanent reinvestment offshore - reflecting the Company's expectations that they will never be subject to U.S. taxation - are now in excess of \$50 billion.

This structure permits Foxtrot to earn and to keep a significant amount of taxable income earned and remaining offshore where it is subject to very low levels of taxation (i.e., the averaged blended cash tax rate on current earnings and profits captured within this foreign structure was less than 10 percent). This is further evidenced by the fact that, although approximately 50 percent of sales for the study period were to U.S. customers, less than five percent of U.S. GAAP consolidated income before income taxes was attributable to U.S. operations. The combination of having significant profit offshore that is subject to relatively low rates of foreign taxation and is what has led to Foxtrot having a worldwide average tax rate for the study period of only 16 percent as compared to the U.S. federal statutory tax rate of 35 percent.

IV. ANALYSIS

A. Overview

Each of the six taxpayers selected to be the focus of the case studies - Alpha, Bravo, Charlie, Delta, Echo, and Foxtrot - was chosen as a result of having low average worldwide tax rates. These companies have certain features in common, as evidenced from publicly available financial data, including: (1) a significant portion of the U.S. GAAP income before income taxes was earned offshore where it is subject to relatively low average foreign tax rates; (2) the taxpayers have asserted that a substantial amount of the accumulated U.S. GAAP earnings offshore is permanently reinvested such that no U.S. tax is accrued for financial accounting purposes; and (3) U.S. income before income taxes as a percentage of worldwide income before income taxes was lower than U.S. sales as a percentage of total sales worldwide.

While there are likely numerous reasons for these reported results, the six case studies share several characteristics. First, the taxpayers appear to follow the principal model in that they have a concentration of their more profitable functions in foreign jurisdictions where the average tax rate is lower and a concentration of their less profitable functions in jurisdictions where the average tax rate is higher. Each taxpayer has established an entity as a foreign principal, typically located in a foreign jurisdiction where the principal is subject to low average corporate income tax rates as a result of the jurisdiction having low statutory tax rates on business income or as a result of negotiations with the local government. This entity may have ownership and responsibility for continued development of intangible property rights. In contrast, lower value functions such as contract manufacturing or limited risk distributor functions are located in jurisdictions as dictated by nontax business needs or historical precedent (e.g., manufacturing is performed in Italy, where the plant has always been located, but it is now done through a contract manufacturing agreement). These were jurisdictions where the average tax rate often is higher. While these entities are essentially guaranteed positive taxable income based on the nature of their contractual arrangements with the principal, the tradeoff is that these subsidiaries enjoy no upside profit potential.

Second, each taxpayer exploits its intangible property rights effectively as part of its foreign operations. One way to accomplish this is by having the foreign subsidiary enter into an agreement with the U.S. group to make a buy-in payment(s) with respect to certain pre-existing intangible property rights (e.g., make-sell rights) and then cost share future development of those intangible property rights attributable to certain product lines that it will make and sell outside the United States or worldwide. Another is for the foreign subsidiary to enter into a license agreement with the U.S. group to make and sell certain product lines either solely outside the United States or worldwide.²⁰³

Third, each of the taxpayers defers a substantial percentage of their foreign earnings by effectively managing their exposure to the subpart F rules. Check-the-box rules are used to

²⁰³ Where cost sharing was not involved and the foreign subsidiary sold the product back to the U.S. group, the U.S. group was often compensated through the transfer price of the product in lieu of the foreign subsidiary paying a royalty.

ensure that cross-border royalty payments made from the principal to the owner of the intangible property are disregarded. Additionally, where the principal entity has intragroup sales to U.S. or foreign subsidiaries, the taxpayers use check-the-box in conjunction with the manufacturing exception to avoid current U.S. tax on foreign earnings under subpart F.

The following is a more in-depth discussion of (1) how each of these characteristics enables the taxpayers to accomplish low average worldwide tax rates, (2) how each of these characteristics as exhibited by the taxpayers interacts with applicable U.S. tax rules including more recent modifications to these rules, and (3) other general issues and considerations that warrant highlighting.

B. Low Foreign Tax Rates

An advantage of much of the business restructuring activity and of many of the legal structures highlighted in the case studies is the ability of taxpayers to generate income in jurisdictions with low tax rates, or in which they have been able to negotiate favorable tax regimes with the local government. The taxpayers in each of the case studies were successful in lowering worldwide average tax rates over the study period as a result of structuring transactions and business operations in a way that allowed them to locate and retain significant business earnings in low-tax jurisdictions. Taxpayers manage tax rates, in part, by moving profit to low-tax jurisdictions using various techniques including shifting intangible property ownership or rights to low-tax jurisdictions, setting up principal structures with the principal located in a low-tax jurisdiction, and minimizing profit in jurisdictions with higher tax rates through the use of contract manufacturers, limited-risk distributors, or by paying royalties or license fees out of high-tax jurisdictions for the use of property located in low-tax jurisdictions.

Shifting income from high-tax to low-tax jurisdictions increases the after-tax earnings of multinational companies. The ability of U.S.-based multinationals to defer financial statement recognition of any residual U.S. tax that would be due on repatriation allows U.S. multinationals to reflect only the foreign taxes applicable to the deferred foreign income, thus preserving the financial statement benefit of the differential between the U.S. and foreign tax rates. Each of the taxpayers in the case studies report significant unremitted foreign earnings for which they accrue no residual U.S. tax for financial statement purposes.

Although the case studies focused on U.S. multinational companies, managing worldwide tax expense is important for foreign-based multinational companies as well. Many of the business and legal structures discussed below are used by both U.S. and foreign multinational companies to locate profit in low-tax jurisdictions and minimize profit in high-tax jurisdictions.

Location of intangible property

One of the key ways taxpayers locate business earnings in low-tax jurisdictions is by locating intangible property in such jurisdictions. As discussed above, this can be accomplished in several ways, including a transfer or contribution of property to a foreign affiliate, through buy-in and cost-sharing arrangements, or through licensing agreements. Intangible property may include products, manufacturing know-how, patents, marketing intangibles, trademarks and trade names, customer relationships, experienced work force, and goodwill.

In each of the case studies, the taxpayers performed a significant portion of the product development, product specification, manufacturing process development and improvement, marketing, patent application process, regulatory approval, trade name development, development of customer relationship, and the creation of other valuable intangible property in the United States, but the rights to exploit the intangible property are either transferred to or licensed by an affiliate in a low-tax jurisdiction.

In lieu of license fees or royalties, a company may structure its transfer pricing of a product with a lower price when it is sold to the U.S. owner of intangible property. This lower

price is intended to compensate the owner for the right to use intangible property related to the product.

Alpha primarily licenses intangible property to Alpha Asia and Alpha Netherlands. For the study period, Alpha Asia paid no foreign income taxes and Alpha Netherlands had an average tax rate of just over three percent. Although these low-tax affiliates paid license fees that were taxable to Alpha in the United States, these affiliates were able to retain much of the profit related to the foreign manufactured products in locations with low tax rates. The profit captured in the low-tax jurisdictions includes profit on products that are designed, marketed, and sold in the United States.

Bravo transferred its global intangible property rights related to certain product lines to Bravo Switzerland in exchange for a series of buy-in payments. Rights to certain newly developed products are owned outright by Bravo Switzerland because Bravo Switzerland pays Bravo U.S. for the development of the intangible property under a cost-sharing agreement. Although Bravo U.S. recognizes taxable income for the cost-sharing payments it receives, is also deducts the R&D costs it incurs. In addition, Bravo U.S. may qualify for U.S. tax credits related to the R&D costs. Bravo Switzerland, in turn, licenses its rights to manufacture and distribute these products to Bravo Netherlands. Bravo Switzerland pays tax on royalty income in Switzerland but claims a Swiss tax deduction for the cost-sharing and any buy-in payments made to Bravo U.S. Bravo captures profit in low-tax jurisdictions by using a combination of intangible property location, the principal structure, and limited-risk distributors.

Charlie currently licenses intangible property to Charlie Cayman. Delta also licenses much of its intangible property to Delta Netherlands generally at a point in the process when the product is nearly ready for sale to third parties. In turn, Delta Netherlands may contribute the rights to its manufacturing affiliates for use in manufacturing the product. Echo has both licenses and cost-sharing arrangements it uses to exploit intangible property in low-tax jurisdictions. It licenses intangible property to Echo Cayman Islands for use in its Puerto Rico operations and has cost-sharing agreements in place for products manufactured and distributed by Echo Europe and Echo Europe Trading. For the study period, Echo's average tax rate related to the manufacturing and distribution of product associated with the transferred intangibles was less than two percent.

Foxtrot entered into a buy-in and cost-sharing agreement with Foxtrot Bermuda for the intangible property related to products distributed outside of the United States. In turn, Foxtrot Bermuda licenses the rights to manufacture and distribute the product to Foxtrot Netherlands. The royalty paid to Foxtrot Bermuda is determined under an APA entered into with the Dutch tax authorities, and shifts income from the Netherlands to Bermuda.

The low-tax entities earn profit related to the risks and functions assumed either as the owner or licensee of the intangible property. For example, Alpha Asia and Alpha China assume the inventory risk, manage the third-party contract manufacturers, and are responsible for quality control and the improvement of the manufacturing processes. Bravo Switzerland and Bravo Netherlands bear the risks associated with the manufacture and sale of the products covered by the buy-in and cost-sharing agreements and the licensing agreement between these two DREs. Delta Netherlands assumes the risk of the final R&D necessary for the product to be introduced

in the market and the risk related to the manufacturing process including the risk of time to market, and product quality and reliability.

Assumption of the risks and functions related to the intangible property generally supports the allocation of system profits to the entity located in the low-tax jurisdiction. As well, these entities also bear the risk that a product proves to be a commercial failure. Similarly, during economic downturns, these entities bear the risks that losses will accumulate in the low-tax jurisdiction. A company can accrue losses at low tax rates when payments under buy-in, cost-sharing, licensing, or royalty agreements, and other costs associated with the manufacturing and distribution of the product are greater than revenues from the product.

Use of principal structure

As discussed in Part I above, taxpayers may align their supply chain structure in a way that minimizes their worldwide taxes. While the principal structure is often chosen for its cost savings from centralizing purchasing or other functions, in order to minimize overall tax burden, the taxpayer may locate the principal in a low-tax jurisdiction. The principal assumes certain functions and risks associated with various functions of the supply chain. This assumption of risks and functions entitles the principal to retain profit from the manufacture and sale of the products for which it is responsible.

Bravo uses a principal structure with Bravo Netherlands as the principal. Bravo Netherlands assumes risks related to product success, product quality, manufacturing risk, marketing risk, inventory risk, and credit risk with respect to customer sales. Although Bravo Netherlands acts as a limited-risk distributor and receives a small percentage of the profits related to products manufactured in the United States for distribution throughout Europe, its primary source of earnings is from its role as principal in the manufacture and worldwide distribution of products for which Bravo Switzerland owns the intangible property rights. Bravo Netherlands pays a royalty to Bravo Switzerland for the use of the intangible property. Bravo Netherlands manufactures products through the use of third-party contract manufacturers and sells products to unrelated customers through limited-risk distributor DREs or CFCs. For its services as principal, Bravo Netherlands retains much of the profits from the manufacturing and distribution of products. Bravo Netherlands and Bravo Switzerland and several of the DRE commission agents are organized under Bravo Bermuda. Over the study period, Bravo Bermuda had an average tax rate of less than four percent of earnings (including taxes of its DREs, Bravo Netherlands and Bravo Switzerland).

Foxtrot also uses a principal structure with Foxtrot Netherlands as the principal. Foxtrot Netherlands is responsible for the manufacture and distribution of products outside of the United States. Foxtrot Netherlands contracts with Foxtrot H.K. for the manufacture of product, and distributes product through CFC distributors. Foxtrot Netherlands and Foxtrot H.K. are DREs organized under Foxtrot Bermuda. Over the study period, Foxtrot Bermuda had an average tax rate of ten percent of earnings.

As with the location of intangible property, locating a principal in a low-tax jurisdiction can also result in an accumulation of low-tax losses if the products controlled by the principal do not generate revenues in excess of expenses.

Limiting profit in high-tax jurisdictions

It is generally not possible for a taxpayer to structure its operations so as to entirely avoid high-tax jurisdictions. Companies may have distribution channels and customer support activities located where customers are located, or products may be difficult or expensive to ship, requiring manufacturing to take place where the product is ultimately used. Such operations might be structured in a way that minimizes the profit earned in the high-tax jurisdictions by limiting the functions and risks in such jurisdictions. As explained in more detail in Part I, Business Restructuring above, this can be accomplished through the use of limited-risk distributors and contract or toll manufacturing.

Alpha employs a strategy that somewhat mitigates its U.S. tax exposure related to sales by Alpha Asia directly to key U.S. customers. On these sales, Alpha U.S. acts as a commissioned sales agent, receiving a commission intended to compensate Alpha U.S. for its sales related activities. Bravo uses limited-risk distributors in high-tax jurisdictions. For Bravo Switzerland products, Bravo U.S. acts as a limited-risk distributor for product sold into the United States. Bravo compensates its limited-risk distributors in a manner that ensures, on a net basis, a two-percent return on sales.

Delta U.S. also distributes product in the United States and in return the transfer price reflects compensation for its distribution services. The return is determined based on the status of the product's patent protection to reflect the level of commercial risk assumed by Delta U.S. Delta U.S. assumes less marketing risk if the patent protection is expired. As a result, the transfer price for such product is higher than for a patent-protected product. Delta distributes products outside of the United States through foreign affiliates with the same pricing structure and limited return to the distributors as is provided for sales to Delta U.S. Echo distributes products outside the United States through its commissionaire structure. Echo Europe Trading, the commissionaire, retains earnings of two percent on its global sales.

Additionally, transactions can be structured to result in royalties and other payments from higher-tax jurisdictions to entities in lower-tax jurisdictions. For example, Foxtrot Netherlands compensates Foxtrot Bermuda through a royalty for the use of intangible property rights owned by Foxtrot Bermuda. This royalty payment moves earnings from the higher-tax Netherlands to the lower-tax Bermuda. Foxtrot Netherlands entered into a Dutch APA that established the amount of Dutch taxable income Foxtrot Netherlands is required to earn each year. The Dutch government, and governments of other jurisdictions, may believe that it is worth the cost of some loss of tax revenue in order to attract the investment of companies such as Foxtrot Netherlands.

Foreign-based multinational companies also use these structures, often structuring U.S. and other high-tax distribution channels as limited-risk or commission-based to limit their tax exposure. Similarly, contract or toll manufacturing is used by foreign-based multinational companies in the U.S. and other high-tax jurisdictions.

Availability of special tax regimes

Multinational companies are sometimes able to negotiate lower tax rates or are eligible to participate in special tax regimes offered by jurisdictions to attract foreign direct investment.

These special tax regimes are often dependent upon the multinational company engaging in the types of activities that the jurisdiction is trying to attract. Some examples include special tax regimes for specific business sectors (such as the insurance or financial sectors), the location of certain types of property (such as intangible property or manufacturing facilities), or engaging in certain types of activities (such as supply chain or shipping activities) within the local jurisdiction.

Bravo and Delta each benefit from special tax regimes offered in local jurisdictions. Income that is subject to tax at the 25.5 percent Dutch tax rate is limited pursuant to a tax ruling that Bravo Netherlands negotiated with the Dutch tax authorities. Delta's Puerto Rico, Irish, and Singapore manufacturing operations benefit from incentive tax grants and incentive tax rates in the jurisdictions in which they operate.

Use of leverage to minimize foreign tax rates

Although not highlighted in the case studies, leverage is also used to shift income from high-tax to low-tax jurisdictions. For example, it is common for foreign parent companies to leverage their U.S. operations, resulting in interest deductions at the higher U.S. tax rate and interest income in lower-tax jurisdictions.²⁰⁴ Taxpayers strategically use low-tax jurisdictions as the lenders in these transactions. Access to a robust treaty network is often a key consideration to limit or avoid withholding tax on interest payments. Additionally, U.S.-based multinationals structure debt in a manner that avoids subpart F income (for example, through the use of check-the-box entities).

²⁰⁴ The ability to leverage U.S. operations is limited under section 163(j). Many countries impose similar limitations on the amount of debt that can be used to erode the local tax base.

C. Transfer Pricing

Overview

Transfer pricing allocates system profits to each entity that participates in the supply chain. Each of the case studies involves a U.S.-based multinational company that uses intangible property developed in the United States in the manufacture of finished goods outside of the United States. In each case, a significant portion of those finished goods is ultimately sold in the United States. In some cases, there are several cross-border transactions between related parties involving the transfer of goods and services, including distribution, service, and manufacturing agreements. Each such transaction has its own transfer price that must be determined based on the facts and circumstances unique to the transaction, but which might also be evaluated on an overall basis, taking into account the amount of system profit that is allocated to each party on a net basis. This means that while the transfer price for one agreement may not reflect an arm's-length result, overall, there may still be an arm's-length result to each party. Both cross-border licensing and cost-sharing arrangements were present in the case studies.

The United States, like most of its trading partners, permits the immediate deduction of R&D costs, and also provides additional tax incentives (including the R&D credit) to induce taxpayers to undertake R&D investment in the United States. In exchange, the United States expects a return in the form of tax on income generated as a result of the R&D investment. If taxpayers shift the benefits of their R&D out of the United States without adequate compensation as a result of an understated transfer price, the United States does not receive its expected return.

Unique intangible property is particularly difficult to value. Consequently, royalty payments, license fees, and buy-in payments are particularly difficult to value – both for the taxpayer and for the IRS. First, taxpayers that develop unique intangible property rarely, if ever, transfer that property to third parties; as a result, it is difficult to determine the terms under which an arm's-length transfer of the property might have occurred. Even when a comparable transaction is identified for application of the arm's-length standard, the taxpayer possesses inside knowledge regarding the differences between the taxpayer's specific circumstances and those of the proposed comparable transaction. The information available to the taxpayer that was not available in the comparable transaction affects of comparability, and should not be taken into account when establishing the transfer price. Such information asymmetry favors the taxpayer in establishing transfer prices and resolving transfer pricing disputes.

Second, transfers to related parties normally do not involve the bona fide shifting of economic risk that would occur in transactions between unrelated parties. As discuss above in more detail in the Present Law section on Transfer Pricing, an important aspect of transfer pricing is the notion of each company's separate corporate existence for tax purposes. Because the separate existence of each company in the group is respected, risk can be assigned by contract to any member of the group with the objective ability to bear that risk, even though risk does not leave the affiliated group.

Cost sharing

Overview

Cost-sharing arrangements have long been a central component of business restructuring activities.²⁰⁵ The Conference Report that accompanies the Tax Reform Act of 1986 states that the conferees did not “intend to preclude the use of certain bona fide R&D cost-sharing arrangements,” provided that the results under the arrangement were consistent with the commensurate-with-income principle.²⁰⁶ More recently, cost-sharing arrangements have been the subject of news reports²⁰⁷ and litigation.²⁰⁸

The decision to cost share the development of an asset is an investment decision, and the profits earned on the exploitation of the newly developed asset represent the return on investment. In cost sharing, two or more entities make that investment by contributing resources toward the joint development of a new marketable asset. Often, one company contributes the right to use existing intangible property for R&D (a platform contribution), and the other company makes a buy-in payment (either as ongoing royalties or an upfront lump sum payment) to acquire those rights. The entities divide the rights to the asset being developed and then each contributes its share of the development costs, based on the expected profit potential of the rights it has been allocated under the arrangement.²⁰⁹ Because the economic ownership of the newly-developed asset is divided between the cost-sharing participants, no royalties are paid when the new product is ultimately marketed and sold to customers.

The transfer pricing question is whether the investment was appropriately priced under the arm’s-length standard. It is the value of buy-in payments that is the source of many controversies in cost-sharing cases. The 2008 regulations, discussed in more detail below,

²⁰⁵ See e.g. Prop. Treas. Reg. sec. 1.482-2(d)(4) (published on August 2, 1966, this proposed regulation provided extensive rules for cost sharing arrangements between related entities).

²⁰⁶ H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986).

²⁰⁷ See e.g. Glenn Simpson, “Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe,” A.1. *Wall Street Journal*, Nov. 7, 2005. As reported, valuable intellectual property rights had been transferred to a four-year old Irish subsidiary of a U.S.-based high tech company from the United States through cost-sharing arrangements. At the time, the Irish employees represented less than four percent of the company’s workforce, yet controlled \$16 billion in assets and nearly \$9 billion in gross profit. What the article hints at, but does not clearly state, is that the Irish subsidiary paid for the initial transfer of intangible property, and the U.S. transferor was taxable in the United States on that cost-sharing buy-in payment. Given the absence of docketed or settled litigation between the IRS and the company, it appears that any dispute over the amount of the buy-in, if there was one, was resolved at the administrative level. The company disclosed in its 2008 Annual Report that it had recently paid \$3.1 billion in settlement of the IRS audit of its 2000 – 2003 tax returns. See *Microsoft Annual Report 2008*, Note 11, available at http://www.microsoft.com/msft/reports/ar08/10k_fr_not_10.html. The extent, if any, to which this settlement payment related to the cost-sharing payment received from its Irish subsidiary is unclear.

²⁰⁸ See e.g. *Veritas Software Corp., et al. v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) and *Xilinx, Inc. v. Commissioner* 125 T.C. 37 (2005), *aff’d* No. 06-74246 (9th Cir. Mar. 22, 2010).

²⁰⁹ There are numerous variations on this basic description of a typical cost-sharing arrangement.

provide detailed guidance on the valuation of buy-in payments.²¹⁰ The Joint Committee staff is aware that buy-in payments have been the focus of IRS administration and audit adjustments are often proposed.

In addition, if the taxpayer provides R&D services in connection with the cost-sharing arrangement, the taxpayer is compensated for those services. The costs incurred by that taxpayer in the provision of such services that must be shared (specifically, stock option expenses) are another source of controversy. The 2008 regulations provide detailed guidance on the calculation of costs that must be shared.

With respect to the intangible property produced through a cost-sharing arrangement, U.S. transfer pricing rules are relevant. For example, the periodic adjustment provision may be operative with respect to the initial transfer.²¹¹ However, because the foreign cost-sharing participant has substantial rights in each subsequent generation of the intangible property, U.S. transfer pricing rules are less relevant with respect to the taxation of foreign income they generate.

As related taxpayers have the unilateral ability to decide whether to participate in a cost-sharing arrangement and what intangible property to jointly develop with a related entity, cost-sharing arrangements within an affiliated group are not particularly risky investments. Nonetheless, despite this flexibility, the commercial success of a cost-sharing arrangement is not guaranteed.²¹²

Case studies

Bravo, Echo, and Foxtrot each have cost-sharing arrangements that pre-date the issuance of the 2008 regulations. The economic rights to the existing intangible property made available through the cost-sharing arrangement are now owned outside of the United States. This affects

²¹⁰ These regulations are described in the Present Law section.

²¹¹ For the rules on when periodic adjustment may become inoperative, see Treas. Reg. sec. 1.482-4(f)(2)(E) and Temp. Treas. Reg. sec. 1.482-7T(i)(6)(iv)(B).

²¹² In one case, a U.S. company shifted ownership of its most important intangible property to Ireland through a cost-sharing arrangement by having its Irish units share the cost of R&D. The business restructuring plan, which included centralization of operations in Ireland, anticipated that \$3.4 billion in pre-tax profit (approximately \$700 million of which would come from the United States) would shift to Ireland, and that the company would ultimately be able to achieve an average global tax rate of 30 percent or better. When projected operating profits did not materialize, operating losses (worldwide and in Ireland) magnified the impact of the loss for financial statement purposes, with one result being that the average tax rate increased to 38 percent, from 31 percent. The increase in the effective tax rate reflected the effect of losing money in a low-tax jurisdiction, where the tax benefit of a net operating loss based on Ireland's tax rate (in this case, the company expected tax rates between 10 percent and 12.5 percent) was significantly less than the tax benefit of that same net operating loss at the 35-percent rate applicable in the United States. See James Bandler and Mark Maremont, "How a Xerox Plan to Reduce Taxes and Boost Profit Backfired," *Wall Street Journal*, C1., Apr. 17, 2001. The fact that any U.S. GAAP financial statement tax "benefit" (which is really a detriment when compared value of the losses at the U.S. tax rate) for the losses would be computed at a 10-percent or 12.5-percent Irish statutory tax rate instead of the 35-percent U.S. statutory tax rate would have been one of many factors contributing to the average tax rate increase to 38 percent.

each company's worldwide tax liability, as these assets give rise to active foreign earnings that are generally deferred from current U.S. tax. However, Bravo, Echo, and Foxtrot have recognized U.S. taxable income from the buy-in payments received as compensation for their respective platform contributions.

As stated above, buy-in and ongoing cost-sharing payments by the foreign cost-sharing participant are investments. In return, the foreign cost-sharing participant owns specified rights to market the newly developed assets. In Bravo's case, the foreign cost-sharing participant recovered its investment in less than three years.

2008 Regulations

Investor model

In late 2008, Treasury and the IRS issued the proposed cost-sharing regulations in temporary form (discussed in detail above in "Present Law").²¹³ As proposed regulations, these rules remain open for taxpayer comment. While they are presently applicable to taxpayers, the 2008 regulations expire on or before December 30, 2011.²¹⁴

One of the most important developments under the 2008 regulations is that the investor model, a financial model for determining buy-in payments, is now part of the applicable regulatory framework. While this development does not reach back to recapture any cost-shared assets or related earnings located outside the United States at the time the 2008 regulations were issued, it does provide a definitive date from which the investor model applies for purposes of valuing buy-in payments.

In each of the case studies, a U.S. company was the exclusive source of the initial platform contribution of intangible property; the foreign participants only contributed cash. Under the investor model, a cost-sharing participant that contributes nothing but cash is viewed as taking a low-level of risk with respect to the platform contribution, as that risk was already taken by the original developer. Consequently, the risk adjustments that would be made when calculating the buy-in payment would have the effect of increasing this cost-sharing participant's buy-in payment over that of the hypothetical cost-sharing participant that makes a risky initial investment (e.g., the intangible property is at an earlier stage of development, or complementary self-developed intangible property contributed). Therefore, by increasing the taxable buy-in payment by so-called foreign "cash-box" subsidiaries, the 2008 regulations should temper future investment by such entities in cost-sharing arrangements involving intangible property developed in the United States. Accordingly, if Bravo, Echo, and Foxtrot were considering the same types of transactions today, it is unclear whether they would enter into cost-sharing arrangements.

²¹³ T.D. 9441, 2009-7 I.R.B. 460. These regulations are described above in the Present Law section.

²¹⁴ Temp. Treas. Reg. sec. 1.482-7T(n).

Transition rules

Although the 2008 regulations generally apply to current arrangements like those of Bravo, Echo, and Foxtrot, they also include several transition rules for taxpayers with existing qualified cost-sharing arrangements that met substantive documentation requirements during 2009.²¹⁵ These transition rules relate to the test applicable in making commensurate-with-income adjustments and the exclusivity of the field if use as allocated by the cost-sharing agreement. The commensurate-with-income rules can result in an increase in the buy-in payment. In determining whether to qualify their existing cost-sharing arrangements under the transition rules, Bravo, Echo, and Foxtrot would likely have compared their possible results under the test provided in the 2008 regulations to the alternative, the test provided in the regulations generally applicable to intangible property transfers.

As described above in “Present Law,” qualifying for transition relief sanctions existing cost-sharing arrangements that do not conform to the provisions regarding exclusivity of field of use, permitting the previously agreed allocation. If a cost-sharing arrangement does not conform to rules regarding exclusivity in the field of use (discussed above under Present Law), and did not qualify for transition relief, in certain circumstances one or more of its participants could be required to make an additional buy-in payment.

Subsequent additions

Bravo, Echo, and Foxtrot each have a history of acquiring competitors, then adding acquired intangible property to the cost-sharing arrangement. Assuming their cost-sharing arrangements are grandfathered, these taxpayers may still need to consider the commensurate-with-income rules under the 2008 regulations if, due to acquisitions, they plan on making any new platform contributions into the arrangement before the regulations expire in 2011. If at any point the cumulative effect of subsequent platform contributions is considered a material change to the grandfathered cost-sharing arrangement, the commensurate-with-income rules of the 2008 regulations would apply to that contribution (but not to the rest of the grandfathered cost-sharing agreement).²¹⁶ As the 2008 regulations define “platform contribution” more expansively than its equivalent under prior rules, the more expansive definition of a platform contribution may have the effect of increasing the taxable buy-in payment to a U.S. participant making the subsequent platform contribution.

Stock option expenses

The Joint Committee staff is aware that the issue presented in *Xilinx* (i.e., whether stock option costs must be cost shared) continues to be the focus of IRS efforts to administer section 482 and that audit adjustments may be pending. The precedential authority of the opinion in *Xilinx v. Commissioner*, as an opinion of a court of national jurisdiction, affirmed by a circuit in which a number of taxpayers are located, cannot be disregarded. Nevertheless, it is important to

²¹⁵ Temp. Treas. Reg. sec. 1.482-7T(m)(1).

²¹⁶ Temp. Treas. Reg. sec. 1.482-7T(m)(3).

note that the regulations applicable to the years before the Court (1997 through 1999) did not specifically address the treatment of stock-based compensation, and did not have a rule that expressly provided for coordination with the arm's-length standard set forth in Treasury Regulation section 1.482-1(b)(1).

In 2003, Treasury finalized regulations that explicitly required that stock-based compensation be included in costs to be shared under a qualified cost-sharing arrangement. That regulation also explained that adherence to the requirements of the cost-sharing regulations was necessary in order to satisfy the arm's length standard, providing a specified method to be used in all such arrangements. This prescribed use of the specified methods was carried over to the 2008 regulations. The explicit regulatory definition of the arm's length standard in the context of cost sharing, together with the explicit regulatory inclusion of stock option expenses as a cost that must be shared, should limit the applicability of *Xilinx*. Moreover, the preamble to the 2003 regulations, as well as the 2008 regulations, make clear that the regulation was intended to clarify that the sharing of "all costs" required sharing of stock-based compensation expenses, and the regulation defines the arm's length standard in the context of related-party cost sharing. The transition rules in the 2008 regulations do not grandfather the inclusion of stock option expenses as a cost that must be shared.²¹⁷

The majority of all research and development activity undertaken by each of Bravo, Echo and Foxtrot is performed in the United States. Executives and employees at each of the companies studied may participate in stock option plans. Therefore, under the 2008 regulations, cost-sharing payments made by Bravo, Echo, and Foxtrot are required to reflect expenses for any stock-based compensation.

Licensing

Overview

Anecdotal evidence suggests that cost sharing is not the predominant method by which intangible property is transferred for use outside of the United States. Rather, in most cases, intangible property developed in the United States is licensed to foreign subsidiaries.

Whether the royalty rate paid by the foreign manufacturer is adequate to compensate the owner of the intangible property is an important question when evaluating a cross-border license. However, license agreements are rarely executed in isolation. Typically, there are several collateral agreements that provide for ancillary services. For example, a make/sell license from the U.S. Parent to the Foreign Subsidiary will likely be accompanied by a distribution agreement from the Foreign Subsidiary to the U.S. Parent. The distribution agreement may require the U.S. Parent to provide administrative and back-office services to the Foreign Subsidiary on a cost-plus basis. In addition, an R&D agreement may require the U.S. Parent to provide R&D services to the Foreign Subsidiary on a cost-plus basis.

²¹⁷ Temp. Treas. Reg. sec. 1.482-7T(m)(2).

The fundamental transfer pricing question in a cross-border license is whether, on a net basis, sufficient system profits have been allocated to each party to adequately compensate for the contribution of resources to, and assumption of risks in, the supply chain. The inherent complexity in this analysis is made more difficult as a result of information asymmetry (i.e., the fact that the taxpayer inherently has more complete knowledge of its own facts than does the IRS). Because the IRS is required to make its analysis available to the taxpayer when proposing an audit adjustment, the taxpayer is well positioned to use knowledge of its own facts to argue that the case made by the IRS is analytically deficient.

Case studies

Delta typically executes a make/sell license with a foreign manufacturing affiliate near the end of the R&D phase, when the viability of the product is more certain, and generally less development risk remains. At that point, the related foreign manufacturer assumes the financial risk for the remainder of the R&D phase. Both the timing of the agreement with respect to the development phase, as well as the nature of the contractual arrangements between Delta U.S. and Delta Netherlands, would directly impact the selection of comparable transactions by Delta. From a transfer pricing perspective, the question is whether Delta has selected sufficiently similar transactions between unrelated parties as comparables in pricing its own license agreement. In making this determination, the extent to which Delta U.S. has selected transactions at an earlier development stage (which would suggest a lower royalty rate because product success is more uncertain) or at the end of the R&D stage, when the product is ready to bring to market (which would suggest a higher royalty rate because the product is viable) are relevant considerations.

In Delta's selection of comparable transactions, the business segment of the proposed comparable transaction is relevant. For example, industries have different R&D processes with different level of risk relative to each stage in the process. The pharmaceutical industry is an example where R&D occurs in defined stages for which the associated risk level is well understood by industry experts. As a drug successfully progresses from Phase 1 of clinical development through Phase 3, and on to Registration,²¹⁸ it becomes increasingly more likely that Food and Drug Administration approval to market the drug in the United States will be granted. It is not likely that a license agreement executed between unrelated parties at the end of Phase 1 is sufficiently similar to a license executed between unrelated parties upon Registration so as to provide a reliable measure of an arm's-length result for the Registration license because the risk profiles of the two licenses differ significantly. On the other hand, a license agreement executed

²¹⁸ In Phase 1, an experimental medicine is administered to humans for the first time. Phase 1 clinical trials usually focus on safety and tolerability, rather than the effectiveness of a new medicine. Phase 2 of the trials focuses on the effectiveness of an experimental medicine in treating an illness or medical condition. Phase 3 trials test the results of earlier trials in larger populations and gather additional information about the effectiveness and safety of an experimental medicine. Registration, the next step in bringing a new medicine to market, is the filing of an application with the health regulatory authority of a country to obtain approval to market the new medicine. Phase 4 clinical trials are conducted after the regulatory approval of a medicine for purposes of collecting additional information about long-term risks, benefits, and optimal use.

between unrelated parties at the end of Phase 3 may be a comparable transaction with respect to the Registration license.

The contractual arrangements with respect to Echo's Product X, in which critical, high-value components are manufactured in the United States by Echo U.S., sold and shipped to Echo Cayman Islands, incorporated into the finished product, and then sold back to Echo U.S. for sale to the end customer, are commonly referred to as "round-trip" transactions. The question raised by a round-trip like Echo's is whether the entity providing the component that makes the round-trip has been adequately compensated after taking into account the net result of all contractual payments. This is a factual determination that requires the taxpayer and IRS audit team to understand all of the risks and functions (in substance and not just in form) of Echo U.S. and Echo Cayman Islands to adequately establish an arm's-length result.

In the Alpha case study, there is no explicit license, and the royalty payment does not cover all property manufactured by Alpha Asia. The transfer pricing question is whether the two-percent commission payment to Alpha U.S. adequately compensates Alpha U.S. for the earnings it gave up when Alpha Asia started selling directly to the former Alpha U.S. key-customer base. In making this determination, the extent to which Alpha U.S. reduced its risks and functions by transferring its responsibility to serve these key customers to Alpha Asia is a relevant consideration. For example, if these key customers are high-maintenance clients, or Alpha Asia must continually and aggressively compete to maintain its shelf space in their stores, Alpha Asia may have taken on both the risks and the marketing activities (including costs) inherent in these key-customer relationships, in both substance and in form.

In contrast, if these key customers routinely buy Alpha products as a matter of course, then in substance it would appear that Alpha U.S. has given up earnings, but no risk, and little marketing activity. In this case, the two-percent commission would be evaluated under the arm's-length standard taking into account that the purported shift of functions and risks from Alpha U.S. to Alpha Asia is in form only, such that Alpha Asia is not taking on any substantial risk. In addition, a price adjustment may be warranted if the total compensation to Alpha U.S. is too low based on the realistic alternatives available to Alpha U.S. – specifically, the realistic alternative that it could resume selling to the key-customer base.

Manufacturing return

In the cases studied, each of the foreign manufacturing subsidiaries appears to have taken on numerous rights and responsibilities through their contracts with the U.S. licensor. The Joint Committee staff is aware that, on audit, the IRS sometimes challenges, and proposed adjustments reflect, whether such foreign manufacturing subsidiaries should be treated as full-risk manufacturers or more like toll or contract manufacturers with cost-plus returns.²¹⁹

Contractual arrangements typically provide that the foreign manufacturing subsidiary assumes economic responsibility for risks such as product liability and future R&D. In addition,

²¹⁹ Where it is determined that the foreign manufacturing subsidiaries is treated as a contract manufacturer, the licensor is generally considered the principal in the arrangement.

a foreign manufacturing subsidiary might assume responsibility for providing expertise and services such as manufacturing know-how, process engineering, and materials management. If the foreign manufacturing subsidiary does not, in substance, take on the risks and functions in the same manner as, and to the extent described by the contracts (i.e., the substance does not match up to the form), then it is likely that the foreign manufacturing subsidiary should be treated more like a contract manufacturer, such that the arm's-length price should be established on a cost-plus basis.

In many situations, the taxpayer treats its foreign manufacturing subsidiaries as full-risk manufacturers. The Joint Committee staff is aware that, in many cases, the independent valuations completed in connection with the expiration of the section 936 credit supported this conclusion. A U.S. transferor incurred no exit tax under section 367(d) when foreign goodwill and going concern were transferred to a CFC in the 936 conversion. Accordingly, the U.S. transferor was not averse to a high valuation of such assets. Moreover, a high valuation of these transferred assets supports a taxpayer's position on future tax returns that the CFC is a risk-taking entrepreneur, and not just a service provider. Further, because a full-risk manufacturer is able to charge more for finished goods than is a contract manufacturer, there is additional incentive to obtain the highest supportable valuation of the transferred assets as is possible.

There are two uncertainties in this approach: whether the valuation of the foreign goodwill and going concern is overstated, and whether workforce in place is a subset of going concern value. The IRS is pursuing both of these transfer pricing issues on audit, having designated section 936 exit strategies as a Tier 1 audit issue.²²⁰

Both Echo U.S. and Charlie U.S. transferred unidentified assets (consisting of foreign goodwill and going concern, as well as workforce in place) to CFCs as part of their respective section 936 exit strategies. Neither Echo U.S. nor Charlie U.S. paid any U.S. tax on the outbound transfer of these assets. However, Echo U.S. also transferred a comparatively small amount of identified U.S. intangible property to its CFC. Accordingly, Echo Cayman Islands makes periodic royalty payments to Echo U.S. and will do so for a period of no more than 20 years.²²¹ These royalties are taxable in the United States. As they are treated as foreign source income,²²² Echo U.S. may, depending on its foreign tax credit limitation, be able to offset the U.S. tax on these royalties with foreign tax credits associated with repatriated foreign earnings.

The substantial value attributed by Charlie and Echo to the unidentified intangible property transferred to the CFCs is consistent with the taxpayers' position that these CFCs are full-risk manufacturers and the high transfer price being charged for finished goods (as evidence by the gross profit margin). Once outside the United States, the profit earned by the CFCs on the sale of finished goods to Echo U.S. and Charlie U.S. is generally deferred from U.S. tax and not included as subpart F income based on the manufacturing exception to subpart F.

²²⁰ See discussion in "Present Law."

²²¹ Temp. Treas. Reg. sec. 1.367(d)-1T(c)(1) and (3).

²²² Sec. 367(d)(2)(C).

If the IRS were to successfully challenge, and thereby reduce, the taxpayers' valuations of their unidentified intangible property, the transfer price paid by Charlie U.S. and Echo U.S. would need to be reevaluated, with the likely result that the allocation of system profits to the foreign subsidiary would be reduced. Similarly, this would also be the outcome if a court were to determine that workforce in place does not qualify for the exception because it is intangible property under section 936(h)(3)(B) or it is not a subset of foreign going concern value.

Determining the "best method"

In general, a full comparability analysis (including a functional analysis) is performed on both participants in a related-party transaction to determine which transfer pricing method provides the most reliable measure of an arm's-length result. The most reliable method is the "best method."²²³ In several of the case studies, the IRS examined whether the pricing method used by the taxpayer achieved an arm's-length result.

If a profit-split method is the best method, the correct party (i.e., the "tested party") for applying "profitability indicators" is identified. Profitability indicators are ratios that measure the relationship between profits and the costs incurred, or resources employed, in connection with earning those profits.²²⁴

Charlie Co. is an example of a taxpayer using a profit-split method, although it is not the exclusive basis of Charlie Co.'s transfer price.²²⁵ For purposes of determining the profit-split, Charlie U.S. is the tested party. Selection as the tested party reflects a judgment that, when compared to those of its foreign manufacturing subsidiaries, Charlie U.S. has the least-complex risks and functions.²²⁶

The Charlie Co. case study was the only one in which a U.S. company was the tested party for purposes of determining the arm's-length result.²²⁷ This is an important distinction, particularly in cases where the best method is a pure application of the profit-split method, because profits allocated to an untested foreign manufacturing subsidiary are generally deferred from U.S. tax under the manufacturing exception to subpart F. If the underlying facts are not

²²³ Treas. Reg. sec. 1.482-1(c)(1).

²²⁴ Treas. Reg. sec. 1.482-5(b)(4).

²²⁵ Under the settlement entered into prior to the study period, Charlie Co.'s transfer price was determined based on a hybrid method that combined the comparable uncontrolled transaction method with a profit-split method. Charlie Co. also determined its transfer prices during the study period based on this hybrid method.

²²⁶ In most cases, a tested party will not own valuable intangible property or unique assets that would distinguish the tested party from unrelated parties. Treas. Reg. sec. 1.482-5(b)(2)(i). The regulation provides that "[T]he tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and required the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located."

²²⁷ In the Alpha case study, Alpha U.S. was chosen as the tested party in determining the commission it should earn on sales to U.S. key customers.

adequately developed in conjunction with establishing the best method and identifying the tested party, inappropriate income shifting may occur in cases like that of Charlie Co., where the tested party is a U.S. company.

Business restructuring

As described above, Charlie U.S. was selected as the tested party because the distribution activities of Charlie U.S. can be more reliably analyzed than the activities of its foreign manufacturing subsidiaries. The low, routine distributor rate of return paid to Charlie U.S. suggests that Charlie U.S. may be a limited-risk distributor. If Charlie Co. was converted from a full-risk, into a limited-risk distributor in a business restructuring, a foreign principal in Charlie Co.'s affiliated group might have taken over such sales functions as credit and collection of the company's receivables (or the risk thereof); pricing, credit policies, product allocations and budgeting; and, regional or global sales strategies. Thus, responsibility for such activities and risk would have been transferred from the United States to the foreign principal.

Implicit in the business restructuring (if, in fact, a business restructuring occurred) is that Charlie U.S. is entitled to a smaller allocation of the system profits as a limited-risk distributor. Whether any compensation was due to Charlie U.S. as a result of the conversion would depend on the facts and circumstances. For example, if Charlie U.S. had exclusive, long-term distribution agreements with its foreign manufacturing subsidiaries at the time of the conversion, it is more likely that compensation was due to Charlie U.S. On the other hand, if Charlie U.S.'s business customers are not long-standing or particularly loyal, and these distribution agreements are non-exclusive, and terminable-at-will without prior notice, it is less likely that compensation was due to Charlie U.S. Any such compensation paid to Charlie U.S. would be domestic-source income and taxable in the United States.

In addition, if Charlie Co.'s foreign principal did not, in substance, take on the risks and functions in the same manner, and to the extent described by, the contractual agreements executed in the business restructuring (i.e., the substance does not match up to the form), then it may not have been appropriate to select Charlie U.S. as the tested party. Charlie U.S.'s routine rate of return as a distributor could, therefore, be too low under the arm's-length standard, which would necessitate identifying new comparables.

Internal comparables

"Internal comparables" are transactions between unrelated parties in which one of the parties is the taxpayer itself. In one of the cases studied, the taxpayer used internal comparables to support the transfer price for the global sales and distribution activities of the foreign principal, which is located in a low-tax jurisdiction. It was not clear if the taxpayer had presented all of its internal comparables, or only those that were most favorable in terms of maximizing the foreign principal's return.

The internal comparables appear to be quite similar to the foreign principal's transactions because they are examples of the taxpayer contracting to perform the same functions for unrelated parties. Under the standards of comparability, there are three possible ways for the taxpayer to use its internal comparables in setting the foreign principal's transfer price. First, if

the internal comparables are sufficiently similar to those of the foreign principal, the taxpayer relies on the internal comparables, makes no adjustments, and uses the same pricing. Second, if there are material differences between the internal comparables and those of the foreign principal, but it is possible to determine the impact of those differences on prices or profits with sufficient accuracy, the taxpayer makes adjustments and uses the adjusted price to establish the transfer price for the foreign principal. Third, if it is not possible to determine the impact of material differences on prices or profits with sufficient accuracy, the taxpayer uses the internal comparables in establishing the arm's-length price, but the reliability of the internal comparables as a measure of an arm's-length result is reduced.

In the case studied, the taxpayer presented several internal comparables, with a range of prices. As the taxpayer's transfer price was within the range of prices established by the internal comparables, it appears the taxpayer made no adjustments, such that there were no material differences between the foreign principal's related-party transaction and the internal comparable transactions. As a result, the transfer price positioned the foreign principal to earn approximately the same return on its sales and distribution activities that the taxpayer had earned in the contracts it had negotiated with unrelated parties.

In this case, it was the U.S. parent of the foreign principal that was providing sales and distribution services pursuant to the internal comparables. The taxpayer's reliance on the internal comparables without adjustment indicates that the sales and distribution network of the U.S. parent is sufficiently similar to that of the foreign principal that its internal comparables provide a reliable measure of an arm's length result.

In determining comparability, the U.S. parent's ability to leverage its market position when negotiating third-party sales and distribution agreements should be a relevant data point. For example, if the U.S. parent is (1) known in its industry for its high-quality sales and distribution network, and (2) the counterparties had little market presence before aligning their products with the U.S. parent, it may be that the U.S. parent had a strong negotiating position. In this example, to achieve an arm's length result, the foreign principal and its customer base would need to be similarly situated (i.e., the foreign principal is well known in its industry for its high-quality sales and distribution network, and its customers – which are captive affiliates – had little market presence when they first aligned with the foreign principal).

If a transfer pricing dispute based on the use of internal comparables were to escalate into litigation, the taxpayer's case might be difficult to refute without extensive investment by the IRS in evaluating the asserted comparability of the internal comparables. This is because, in many regards, internal comparables appear to be identical to related-party transactions.

D. Managing Subpart F Exposure

Overview

In each of the six case studies, the taxpayers manage their exposure to the subpart F anti-deferral rules and minimize the incidence of current U.S. taxation on their foreign earnings. The primary aspects of subpart F planning exhibited in the case studies are (1) avoiding foreign personal holding company income with respect to any intragroup royalty payments; and (2) avoiding the triggering of foreign base company sales income with respect to intragroup sales.

Foreign personal holding company income

The Joint Committee staff is aware that many taxpayers do, in fact, have foreign principal structures in which the foreign principal owns or controls intangible property rights, and serves as the principal with respect to the manufacture and distribution of the taxpayer's products. The staff is also aware that another common structure is for intangible property rights to be owned or controlled by one foreign entity that licenses or sublicenses these rights to another foreign entity serving as the foreign principal. Where these foreign entities would otherwise be CFCs from a U.S. tax perspective, check-the-box elections can be made for both the foreign entity owning the intangible property rights and the foreign entity serving as the principal so the intragroup royalty payment is disregarded and does not require testing under the subpart F foreign personal holding company income rules.

Both Bravo and Foxtrot use check-the-box elections to avoid subpart F on foreign-to-foreign royalty payments. In Bravo, the use of check-the-box in this manner permitted the payment of a royalty from the DRE principal (Bravo Netherlands) to the DRE intangible property rights owner (Bravo Switzerland) to be disregarded for U.S. tax purposes. Similarly, in Foxtrot, this permitted the payment of a disregarded royalty by the DRE principal (Foxtrot Netherlands) to the CFC owner of the intangible property (Foxtrot Bermuda) to be disregarded for U.S. tax purposes.

In general, absent the check-the-box election, this royalty would generate subpart F foreign personal holding company income leading to current U.S. taxation. More recently, however, such a royalty payment may still have avoided subpart F treatment under the CFC look-through rules.²²⁸ As a result, some may have concerns that the use of check-the-box elections and CFC look-through rules has allowed taxpayers to reduce the U.S. tax base by permitting the migration of highly-mobile earnings from high-tax jurisdictions to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under subpart F. As mentioned under Part II, Present law, above, Treasury and the IRS

²²⁸ The CFC look-through rules expired December 31, 2009. However, if the rules are extended, this treatment will continue. The CFC look-through rules of section 954(c)(6) may have also applied during the study period. As a result, the payment of a royalty between two CFC affiliates (rather than two DRE affiliates) may not have been treated as subpart F foreign personal holding company income. Nonetheless, each of the taxpayers in the case studies set up its structure prior to the enactment of the CFC look-through rules and likely did not relying upon the continued extension of the CFC look-through rules in the future.

previously attempted to address similar concerns through the issuance of Notice 98-11 but, subsequently, withdrew this document in light of criticism from Congress and taxpayers.

Supporters of the check-the-box regulations, however, may argue that the use of check-the-box in this manner only reduces foreign taxes, thus ensuring that a future distribution of those earnings back to the United States will result in greater U.S. taxes since the available foreign tax credit is lower. In considering international norms, they note that foreign multinationals headquartered in the vast majority of major industrialized countries can and routinely do use intercompany loans from related finance companies located in low-tax countries to reduce the foreign taxes imposed on their overseas operations without triggering any home country tax under their home countries CFC (i.e., subpart F type) regime.²²⁹ However, a counterargument is that this reduction in foreign tax liability is a primary contributor to increasing the differential between the U.S. statutory income tax rate and the taxpayer's average foreign tax income rate on its foreign earnings. This tax rate differential further encourages U.S. taxpayers to minimize the repatriation of these earnings to the United States and, instead, achieve a financial statement tax benefit by asserting permanent reinvestment on these foreign earnings for U.S. GAAP financial statement purposes.

Some may question whether non-tax reasons necessitate the economic ownership of intangible property rights in an entity that is different from the entity responsible for manufacturing and distribution.²³⁰ Others, however, may contend that legitimate business reasons exist to separate these and other functions by legal entity and that the check-the-box regulations have merely served to facilitate this in a manner that does not have negative U.S. tax consequences. Specifically, a check-the-box election may allow a taxpayer to operate in a jurisdiction in branch form for U.S. tax purposes while having the legal liability protection that may only be afforded by holding assets through a separate legal entity. Moreover, as discussed in Part I, Business Restructuring, in the present business environment many taxpayers operate on a regional basis (e.g., EU-wide) as opposed to country-by-country. The use of check-the-box and the CFC look-through rules have allowed taxpayers to operate from a tax perspective in a manner that reflects these business realities without triggering subpart F.²³¹ Furthermore, as discussed under Part II, Present Law, the check-the-box rules have added much needed simplicity to what previously was a resource intensive process for taxpayers and the IRS in determining entity classification.

²²⁹ John M. Samuels, "American Tax Isolationism," *Tax Notes*, June 29, 2009, pp. 1593-1599.

²³⁰ It is common for taxpayers to retain legal title to their intangible property in the United States to take advantage of U.S. intellectual property right protection and facilitate centralized administration of intellectual property. Arguably, then, legal protection would not be a justification for separating the economic ownership of the intangible property from the manufacturing and distribution activities.

²³¹ The purpose of the look-through rule, as stated in its legislative history, is to allow U.S. multinational companies to redeploy their active foreign earnings overseas with no additional U.S. tax burden. The legislative history provides that CFC look-through was intended to make U.S. businesses and U.S. workers more competitive with businesses based in other countries, many of which grant a similar benefit to their companies. See H.R. Rep. No. 109-304, at 45 (2005).

Foreign base company sales income

In addition to avoiding foreign personal holding company income, each of the taxpayers in the case studies had to contend with the subpart F foreign base company sales income rules. As described under Part II, Present Law, above, unless a CFC meets the manufacturing exception, the CFC has subpart F foreign base company sales income if it receives income (whether in the form of profits, commissions, fees or otherwise) from the purchase of personal property from a person outside the CFC's country of incorporation and its sale to a person outside the CFC's country of incorporation, where either person is related to the CFC.

Each of the taxpayers in the case studies uses check-the-box planning, seeks to satisfy the manufacturing exception, or uses some combination of both to avoid triggering subpart F foreign base company sales income. For the study period, Echo treats Echo Switzerland, through its wholly owned Swiss DRE, Echo Europe, as physically manufacturing products. These products are sold by Echo Europe through its DRE commissionaire, Echo Europe Trading, to third-party foreign customers and other wholly-owned Echo CFCs for resale to third-party customers. As Echo Switzerland meets the tax rate disparity test of the branch rules with respect to the manufacturing activities of Echo Europe and the distribution activities of Echo Europe Trading, it is treated as meeting the manufacturing exception such that none of its sales trigger foreign base company sales income.

Although not highlighted in the case studies, another common structure is the pure distribution company, where the CFC principal purchases finished products from a third-party manufacturer located outside of the CFC principal's country of incorporation for resale to its wholly owned CFC distributor. The CFC distributor, in turn, resells the product to third-party customers located in the CFC distributor's country of incorporation. Although the CFC principal is purchasing the product from a third-party manufacturer, its sale of the product to the wholly owned CFC distributor triggers subpart F foreign base company sales income. However, to the extent that a check-the-box election is made so that the CFC distributor is a DRE of the CFC principal, and the arrangement does not violate the tax rate disparity test of the "sales branch" rule discussed under Part II, Present Law, above, the CFC principal is viewed as having sold the product to third-party customers, avoiding Subpart F foreign base company sales income.

Some taxpayers, including Delta and Echo, treat their foreign principals as meeting the manufacturing exception as a result of physically manufacture the product directly or through a DRE that satisfies the manufacturing branch rule. Others, such as Bravo and Foxtrot, rely on their foreign principals meeting the manufacturing exception through attribution of the activities of related or third-party contract manufacturers. The following is a discussion of the positions taken by Bravo and Foxtrot with respect to their contract manufacturing arrangements including how they are addressed under prior law and may be impacted by the new contract manufacturing regulations.

Contract manufacturing under prior law

Bravo and Foxtrot each treat their foreign principals as meeting the manufacturing exception without the foreign principals engaging in physical manufacturing. In each case study, the principal owns the title to the raw materials and finished goods at all times throughout the

manufacturing process. Bravo Netherlands, the foreign principal in the Bravo structure, treats the activities of its third-party contract manufacturers as being attributed to it, such that the manufacturing exception to foreign base company sales income applies with respect to its sales to Bravo U.S. and the Bravo limited risk distributor CFCs. While the contract manufacturing agreements provide that Bravo Netherlands is the manufacturer with only manufacturing assistance provided by the third-party contract manufacturer, it is unclear to what extent the employees of Bravo Netherlands or even the employees of Bravo U.S., which perform services for Bravo Netherlands under a supportive services agreement, are contributing to the manufacturing process.

Similarly, Foxtrot treats its Dutch principal, Foxtrot Netherlands, as satisfying the manufacturing exception by attribution of the manufacturing activities performed by its related contract manufacturer, Foxtrot HK (a brother-sister DRE). Like Bravo Netherlands, Foxtrot Netherlands also has intercompany agreements stipulating that it is the manufacturer and that Foxtrot H.K. only provides manufacturing assistance. Additionally, Foxtrot treats the general manager at Foxtrot HK as, in substance, an employee of Foxtrot Netherlands. Therefore, the employee's activities support Foxtrot Netherlands maintaining that it has sufficient control and oversight over the manufacturing process.

Whether companies with substantive fact patterns comparable to those of Bravo or Foxtrot actually meet the manufacturing exception has historically been a contentious issue upon IRS audit. As discussed under Part II, Present Law, above, the foreign base company sales income regulations previously did not expressly address the application of the manufacturing exception to contract manufacturing arrangements. Therefore, taxpayers and the IRS could look only to the limited administrative guidance and case law available at that time to apply to the specific facts and circumstances of the taxpayer. Some taxpayers had the requisite substance, as demonstrated by the activities of their employees, to support their position that they meet the manufacturing exception through attribution of the activities of the contract manufacturer. Others, however, may have had very little employee involvement and relied primarily upon the terms of a contract manufacturing agreement which represented that sufficient control and oversight as well as other risks and responsibilities were borne by the principal.

Some taxpayers with very little substance at their CFC principal may have relied primarily upon the "its" argument as a means of qualifying contract manufacturing arrangements for the manufacturing exception. As mentioned in Part II, Present Law, above, a taxpayer might have taken the position that, regardless of the CFC's level of involvement in the manufacturing process, no subpart F foreign base company sales income was generated, because the property the CFC purchased (i.e., the raw materials) was different than the property that the CFC sold (i.e., the finished good). Although these controversial "its" and "naked its" positions have never been litigated, the Joint Committee staff is aware that many of these cases were settled at the administrative level.

Implications of new contract manufacturing regulations

With the issuance of the new contract manufacturing rules in December 2008, taxpayers can no longer rely solely upon contractual rights, legal title, tax ownership and assumption of risk to avoid triggering subpart F foreign base company sales income. The new rules expressly

eliminate the “its” position and introduce a substantial contribution test which provides that, although it is not necessary for the CFC’s direct employees to perform the actual physical manufacturing activities, they must at least make a substantial contribution through nonphysical manufacturing activities. Additionally, the rules are accompanied by new manufacturing branch rules that, among other things, affect the manner in which the manufacturing branch rule is applied to foreign principal structures.

It is unclear in the case study to what extent Bravo Netherland’s employees are already engaged in activities that would constitute substantial contribution under the new rules. Bravo Netherlands may have been relying primarily upon the activities of the employees of Bravo U.S. (compensated under the supportive services agreement), the contractual agreement with its third-party contract manufacturer, or even the “its” position to meet the manufacturing exception. In order for Bravo to continue to meet the exception under the new contract manufacturing regulations, it may be necessary for Bravo Netherlands to ensure that its own employees make a substantial contribution to the manufacturing of products by the third-party contract manufacturer in the future. Given that the new rules apply to tax years beginning after June 30, 2009, Bravo Netherlands may need to make modifications to ensure it meets the new substantial contribution test and does not violate the tax rate disparity test in the new manufacturing branch rules discussed in Part II, Present Law, above.

With respect to the application of these new rules to Foxtrot Netherlands - although its manufacturing activities are performed by a related party, Foxtrot H.K - it is unclear to what extent, if any, Foxtrot must modify its structure to satisfy the manufacturing exception as well as the new manufacturing branch rules.

Some may view the issuance of the new contract manufacturing rules as a much needed modernization of the foreign base company sales income rules to address issues arising under current business structures and practices involving contract manufacturing arrangements. These new rules require that a CFC, through its own employees, makes a substantial contribution to the manufacturing process. For those taxpayers that rely solely on form, and not substance, or the “its” argument, these new rules should change behavior and may require incremental employee costs to continue to achieve the same level of U.S. tax deferral under the subpart F foreign base company sales income rules.

Because these new rules put nonphysical manufacturing activities by CFC employees on equal footing with physical manufacturing by CFC employees, they may be seen by some as a concise roadmap to facilitate future deferral of foreign earnings.

The Joint Committee staff is aware that some taxpayers are electing to apply these new regulations retroactively to open tax years, as they believe it strengthens their position of meeting the manufacturing exception as claimed on prior year tax returns.

Other considerations

In each of the case studies, the principal engaged in cost sharing or licensing of intangible property rights for use in the manufacture and distribution of products. While not a featured characteristic in any of the case studies, many foreign principals use the licensed or cost shared

intangible property for either the performance of services or the licensing of intangible property to third-party customers. Examples may include having the foreign principal license proprietary software to a third-party developer or engage in a franchise agreement with third-party franchisees. For both the performance of services and entering into licenses (or franchise agreements) with third parties, the foreign base company services income rules and the foreign personal holding company income rules, respectively, are designed to ensure that deferral may be achieved only if the CFC principal engages in significant activities of its own in connection with the generation of income.²³² Moreover, in the case of foreign principals that engage in licensing to third parties, meeting the active licensing exception to subpart F foreign personal holding company income generally requires a high level of substance. Nonetheless, to the extent there is concern about the general portability of income attributable to intangible property, these uses of intangible property by foreign principals may warrant consideration.

²³² As discussed under Part II, Present Law, above, Notice 2007-13 narrows the definition of substantial assistance by a related person for purposes of applying the foreign base company services income rules.

GLOSSARY

This glossary is a simplified, non-technical description of some of the common terms used in this pamphlet. It is not intended to be relied upon as providing precise legal descriptions.

2008 regulations – The proposed regulations on cost sharing that were issued in temporary form in 2008. As proposed regulations, they remain open for comment. As temporary regulations, these rules are applicable to taxpayers until they expire near the end of 2011.

Arm's-length standard – This is the basis by which most countries evaluate whether a transfer price has been correctly set. Under the arm's-length standard, the best evidence that a transfer price has been correctly set is if it can be demonstrated that unrelated companies would have negotiated that same price if they had executed the same transaction under the same circumstances. However, since identical transactions between unrelated parties are not likely to exist in reality, generally a taxpayer can refer to the results of comparable transactions under comparable circumstances. Importantly, for purposes of meeting the arm's-length standard, it does not matter that unrelated companies would not have entered into the same type of transaction under the same circumstances.

Arm's-length result – If transactions between related parties meet the arm's-length standard, the allocation of system profits between the related parties is said to reflect an arm's-length result.

Average tax rate – The ratio of a company's worldwide tax expense to its worldwide income before income tax as measured for financial reporting purposes. This is commonly referred to as a company's "effective tax rate." A company's effective tax rate can be found in the Notes to its financial statements in its annual and quarterly filings with the Securities and Exchange Commission.

Berry ratio – The ratio of a company's gross profits to operating expenses. A ratio coefficient of 1 or more indicates that the company is making profit above operating expenses, whereas a coefficient below 1 indicates that the firm is in a loss position. This ratio is often used in transfer pricing as a comparative profit-level indicator.

Buy-in payment – This is the amount that a cost-sharing participant pays to acquire specified rights to existing intangible property in connection with a cost-sharing arrangement. Sometimes these rights are acquired in exchange for an upfront lump sum payment. In other cases, the cost-sharing participant acquires the rights under a make/sell license, and the buy-in payment is therefore structured as a periodic royalty payment. The 2008 regulations introduced new terminology that redefined "buy-in payment" as "PCT payments," (i.e., payments for platform contribution transactions).²³³ This pamphlet adopts the more familiar term, buy-in payment.

²³³ Temp. Treas. Reg. sec. 1.482-7T(b)(ii).

Check-the-box entity – See the definition below for disregarded entity.

Commissionaire – A distribution company that is hired by a principal and that is generally compensated based on commissions. The commissionaire acts in its own name, but on behalf of, and at the risk of the undisclosed principal (i.e., the customer generally does not know that the commissionaire is selling on behalf of the principal).²³⁴ The commissionaire generally does not take title to, or hold inventory, although it may invoice customers directly. The commissionaire may have limited authority to determine prices within guidelines established by the principal.

Commission agent – A distribution company that is hired by a principal and that is generally compensated based on commissions. The commission agent does not sell in its own name, therefore its agency is disclosed to the customer (i.e., the customer knows that the commission agent is selling on behalf of the principal). The commission agent does not take title to or hold inventory, set prices, or invoice customers.

Comparable transaction – Used for transfer pricing purposes, a comparable transaction is a transaction between unrelated companies that is sufficiently similar to the tested transaction (i.e. the transaction between related the companies) that it provides a reasonable basis for setting the transfer price between the related companies under the arm's-length standard.

Contract manufacturer / toll (or consignment) manufacturer – A company that owns a manufacturing operation and, as a service provider, manufactures or processes goods on behalf of the hiring company. A contract manufacturer generally does not have (1) commercial or product liability risk, (1) development cost, or (3) marketing, sales or distribution costs with respect to the products it manufactures. As a result, the contract manufacturer is generally not entitled to any upside profit potential over and above a reasonable return for its services. The contract manufacturer generally earns a guaranteed cost-plus return on the manufacturing services that it provides. The company that hires the contract manufacturer is often called the principal. The main difference between a contract manufacturer and a toll (or consignment) manufacturer is that a contract manufacturer generally owns the raw materials, whereas a toll manufacturer generally processes raw materials are owned by the principal.

Cost-plus / cost-plus return – Pricing method whereby a markup is added to the estimated cost of manufacturing a product or providing a service. This method may provide an arm's-length result when the company is a service provider and bears little commercial risk.

Cost Sharing / cost-sharing arrangement – An agreement between persons to share the costs and risks of R&D as they are incurred in exchange for a specified interest in any property that is developed. Because each participant has an economic ownership interest in specified intangible rights developed pursuant to the agreement, no royalties are paid by the parties when the rights to such intangibles are exploited. Typically, participants that own existing intangible property at the time the arrangement commences make certain rights to that existing intangible property available to the other participants in exchange for a buy-in payment.

²³⁴ Some jurisdictions require disclosure of the agency status of the commissionaire.

Disregarded entity / check-the-box entity / DRE / DE – As used in this pamphlet, disregarded entity (“DRE”) refers to a wholly-owned foreign corporation for which a tax election has been made to treat that company as a branch of its owner. This election is made solely for U.S. tax purposes. As a branch of its owner, transactions between the DRE and its owner are eliminated for U.S. tax purposes. However, if the DRE and its owner are located in different foreign countries (e.g., the owner is a Bermuda corporation and the DRE is a French S.A.), those same transactions will have legal, financial, and tax consequences in those foreign countries. On the other hand, if the DRE is located in a foreign country and its owner is located in the United States, those transactions will have legal, financial, and tax consequences in the foreign country, but (generally) not in the United States.

Income shifting – The migration of business income from one country to another. Often, this term is used pejoratively to refer to the use of aggressive transfer pricing to migrate business income from a high-tax country to a low-tax country. However, companies shift income between jurisdictions as a result of many types of transactions, including the business restructuring transactions discussed in Part I above. In addition, with respect to U.S.-based multinationals, income shifting is not limited to the migration of income from the United States to a foreign country; for example, U.S.-based companies also shift income from high-tax foreign countries to lower-tax countries. Similarly, foreign-based companies shift income from the United States to lower-tax countries.

Low-tax / low-tax jurisdiction – A jurisdiction with statutory tax rates that are low relative to the U.S. tax rate or relative to other foreign tax rates, or a jurisdiction in which taxpayers have been able to negotiate favorable tax regimes with the local government.

Limited-risk distributor – A company that provides distribution services, but does not have any commercial risk with respect to the products it distributes. As a result, the limited-risk distributor is generally not entitled to any upside profit potential over and above a reasonable return for its services. Instead, the limited-risk distributor effectively earns a guaranteed return in exchange for the distribution services that it provides.

Make/sell license – The grant of rights from the owner of intangible property that permits the licensee to make and sell the product that is based on the licensed intangible property.

Platform intangible / platform contribution – Under Treasury regulations, a platform intangible is generally defined as any resource, capability, or right that a related cost-sharing participant has developed, maintained, or acquired outside of the cost-sharing arrangement that is reasonably anticipated to contribute to the development of new intangible property.²³⁵ Implicit in the definition of a platform intangible is that the resource, capability, or right is made available through the cost-sharing arrangement.

Principal / Entrepreneur – These terms are collectively referred to as “principal” in this document. In a multinational company, the principal is the legal entity that is designated as the

²³⁵ See Temp. Treas. Reg. sec. 1.482-7T(c)(1).

risk taker, either on a global or a regional basis. The principal is usually organized in a low-tax country, or where the company can negotiate a favorable tax regime with the local tax authorities. The principal is characterized by centralized responsibility for the development, production, and sale of goods. Activities performed by the principal may include: (1) oversight and operational management of the international business; (2) negotiation, conclusion of contracts, agreement on price, and selection of vendors; (3) sourcing, coordination of market demand, and market forecasting; (4) inventory stock policy and quality control standards; (5) quality assurance (setting standards) and remediation; (6) comprehensive cost accounting and operations finance/controllership; (7) pricing, credit policies, and budgeting; (8) ownership, licensing, management, and development of intangible property; and, (9) strategic logistics planning. The actual performance of these activities is critical for purposes of supporting the entitlement of the principal to its allocation of system profits. If the principal has relatively few employees, or if its employees do not have the requisite competence to perform these activities at the appropriate level of expertise as is required, then substance may not match form. In this event, the taxpayer may be engaged in aggressive transfer pricing in order to inappropriately shift income to the principal.

Subpart F – Sections 951 – 965 of the Internal Revenue Code, the controlled foreign corporation rules for foreign source income. The subpart F rules generally identify the types of foreign income that, when earned by a foreign subsidiary of a U.S. corporation, are taxed currently in the United States. Therefore, subpart F is an exception to the general rule that active foreign earnings are not currently subject to U.S. tax. However, there are numerous exceptions to subpart F that may be used to achieve deferral from current U.S. tax. Some of these are discussed in this document.

Substance vs. Form – Two companies that execute a contract will allocate responsibility for performing any necessary activities between themselves. The allocation of responsibility as provided in the contract is referred to as the “form” of the deal. The actual performance of those activities is referred to as the “substance” of the deal. If either, or both, of the two companies do not actually perform the activities as required by the contract, then the substance does not match up to the form. This is important because contracts between related parties are given great weight in evaluating comparability under the arm’s-length standard. Where substance does not match up to form, a taxpayer may be engaged in aggressive transfer pricing and inappropriate income shifting.

Supply chain – A taxpayer’s supply chain includes the entities and transactions that move a product or service from supplier to customer. From a tax perspective, the definition of a supply chain incorporates the legal entities (which own technology, information, and other resources) and the contractual relationships between those legal entities that govern the terms of moving the product or service from entity to entity as it progresses from supplier to customer. The supply chain may include entities that are related parties, unrelated parties, or both. If the product sold to the end customer is complex and comprised of many components sourced from multiple jurisdictions, the supply chain may include multiple related (and possibly unrelated) party transactions. The role of transfer pricing is to ensure that each entity participating in the supply chain is appropriately compensated for the contribution it makes to the production of the good or service based on the arm’s-length standard.

System profit – With respect to each product, this is the net amount that is determined by taking into account the final selling price, subtracting all costs incurred along the supply chain, and eliminating the results (i.e., profit or loss) of related-party transactions.

Toll (or consignment) manufacturer – See the definition above for contract manufacturer.

Transfer price – The price at which one company sells goods or services to a related affiliate in its supply chain.

Transfer pricing – The system of laws and practices used by countries to ensure that goods and services transferred between related companies are appropriately priced, based on market conditions, such that profits are correctly reflected in each jurisdiction (and not artificially inflated in low-tax countries and depressed in high-tax countries).

U.S. GAAP / U.S. Generally Accepted Accounting Principles – Presently, the rules by which financial statements are prepared in the United States.