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PROPOSED TREASURY REGULATION 1.861-8: A SOLUTION TO THE SECTION 482 ROYALTY PRICING PROBLEMS OF FOREIGN-BASED MULTINATIONAL CORPORATIONS?

In the last few years, there has been a substantial increase in the level of foreign direct investment in the United States.[1] This increase is significant because the United States, in dealing with the local operations of foreign-based multinational corporations,[2] must face fiscal problems which heretofore have haunted only other nations that have had to deal with U.S.-based multinationals:[3] namely, the administrative and statutory difficulties of taxing a local subsidiary on income that is fairly attributable to its operations. This task is made all the more difficult because multinationals have developed a variety of subtle accounting methods for expatriating funds, apart from dividend payments to parent companies, with the result that the financial records of their subsidiaries may show taxable income that has been artificially adjusted downward.[4] One such method is to charge a subsidiary high royalty fees in exchange for licenses granted by the parent.[5] To

1. *See* note 16 *infra* and accompanying text for statistics on the increase in foreign investment.

2. The U.S. operation of a foreign company might be either a branch of the foreign corporation or a subsidiary. A branch is an office of a corporation incorporated under the laws of a country other than the one in which the branch is located. A subsidiary is a distinct *corporation* owned and controlled by a company organized under the laws of a country other than the one in which the subsidiary is located. Authors quibble over whether or not corporations with foreign branches are technically "multinational corporations." This Note will focus on subsidiaries of foreign-based companies, although part of the analysis is applicable to branch operations as well. *See* note 73 *infra.*

3. A great deal has been written about the various problems created by multinational corporations. *See, e.g.,* J. SERVAN-SCHREIBER, THE AMERICAN CHALLENGE (1969); L. TURNER, INVISIBLE EMPIRES (1971); L. TURNER, MULTINATIONAL COMPANIES AND THE THIRD WORLD (1973); R. VERNON, SOVEREIGNTY AT BAY (1971). For a brief outline of problems for the United States created by foreign-based multinationals, see Note, *The Rising Tide of Reverse Flow: Would a Legislative Breakwater Violate U.S. Treaty Commitments?* 72 MICH. L. REV. 551, 554-61 (1974).

4. *See* notes 20 and 28 *infra* and accompanying text.

5. For the purposes of this note, "royalties" are payments for intangible property rights licensed to a recipient. The term "license" will be broadly defined to include the granting of rights to use such intangibles as patents, trademarks, franchises, special methods or processes, and copyrights. *See* Treas. Reg. § 1.482-2(d)(3) (1968), *as amended,* T.D. 6964, 1968-2 CUM. BULL. 203, T.D. 6998, 1969-1 CUM. BULL. 144, T.D. 7170, 1972-1 CUM. BULL. 178 for a comprehensive list of such intangibles.

frustrate such attempts to avoid American taxation, the IRS will have to scrutinize more closely the royalty fees charged to the U.S. subsidiaries of foreign-based multinationals—a process which may require refining current methods for doing so.

Section 482 of the Internal Revenue Code[6] is the general statutory solution to the problem of tax evasion through artificial transfer pricing[7] among related companies. This section gives the IRS the authority to re-allocate income, deductions, or credits between or among affiliates in order to prevent evasion of taxes or to clearly reflect income.[8] The Treasury regulations accompanying section 482 emphasize that an "arm's length" price must be charged in transactions between related companies,[9] but the tests for determining an "arm's length" price are exceedingly vague for cases where no similar transactions can be found between unrelated parties.[10]

Proposed Treasury Regulation 1.861-8 prescribes rules for determining domestic source and foreign source taxable income,[11] and it specifically outlines how business deductions are to be allocated between domestic and foreign income. Because the proposed allocation-of-deductions rules threaten U.S. taxpayers with a reduction in usable foreign tax credits, they encourage higher royalty fees than are presently charged to foreign subsidiaries for licenses granted by U.S. multinationals.[12] If the basic assumptions and principles underlying proposed regulation 1.861-8 are sound, the rules announced therein

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There may be different dimensions to licensing. For example, licenses may be exclusive to the licensee, or non-exclusive, in which case the same license could be sold to more than one licensee. Licenses may be limited as to what use a recipient can make of the intangible (*e.g.*, one licensee could receive the right to use a patented electronic component to manufacture one product, while another licensee could receive the right to use the same component in a different product). Finally, since intangibles are frequently the subject of formal government protection (*e.g.*, by a patent or copyright), granted by a limited jurisdiction (typically a nation), licenses are commonly restricted to the geographic area in which the rights can be exercised.

6. INT. REV. CODE OF 1954, § 482.

7. An "artificial" price is one that does not reasonably reflect the true value or market value of the product or services exchanged. The term "transfer pricing" is used to refer to pricing techniques among related companies. *See* note 28 *infra* and accompanying text.

8. *See* text accompanying note 45 *infra* for section 482 in full.

9. Generally, an "arm's length" price is one that would be charged for the same products or services between unrelated parties under similar circumstances. *See, e.g.*, Treas. Reg. §§ 1.482-2(b)(3), (c)(2), and (d)(2) (1968) (as amended).

10. *See* note 51 *infra* and accompanying text.

11. Proposed Treas. Reg. § 1.861-8, 38 Fed. Reg. 15840 (1973) [hereinafter cited as Prop. Treas. Reg.].

12. A detailed discussion of this may be found in part III, *infra*.

suggest a logical minimum safe-haven area[13] for royalty charges in general. Accordingly, if the regulation is adopted, it may provide very favorable pricing options for foreign-based companies who grant licenses to U.S. subsidiaries, a consequence which may not have been intended.

This Note will examine the implications of proposed regulation 1.861-8 for the administration of section 482, focusing on how a foreign-based multinational corporation might use the principles of 1.861-8 to justify high royalty charges. Before discussing section 482 and 1.861-8, however, it is necessary to more fully develop the role of royalty pricing in the tax planning strategy of global corporations, and to explain why the United States needs to be concerned about transfer prices charged by foreign multinationals.

I

THE INCREASED PRESENCE OF FOREIGN-BASED MULTINATIONALS AND THE NATURE OF ROYALTY PRICING AS A TRANSFER MECHANISM FOR THE GLOBAL CORPORATION

A. Problems of Increased Foreign Investment and Concern Over Intercorporate Pricing

Foreign investors have been increasingly attracted to the world's largest and richest market.[14] By the end of 1973, there was $17.7 billion in direct foreign investment[15] in the United States (a 24 percent increase over the 1972 level),[16] and foreign-controlled global corpora-

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13. A "safe-haven" area describes a range of prices that will be accepted by IRS agents, without a dispute, as arm's length prices. Royalties within the safe-haven area would not be subject to a section 482 reallocation. If the assumptions and principles underlying the proposed section 861 regulations are sound, the same assumptions and principles are logically applicable to royalty pricing.

14. J. Hein, Foreign Direct Investment in the United States: The Non-American Challenge 2-3 (The Conference Board, Worldbusiness Perspectives No. 16, August 1973). Other factors in the increase include the large U.S. capital market, the opportunity to hire skilled U.S. managers and researchers, high real growth rates (comparatively), and the devaluations of the U.S. dollar.

15. "Direct investment" refers to equity ownership accompanied by managerial control, whereas "portfolio investment" is passive [*i.e.*, the investor does not seek managerial control].

16. In 1971, there was $13.7 billion in foreign direct investment in the United States; in 1972, $14.3 billion. Leftwich, *Foreign Direct Investment in the United States in 1973*, Survey of Current Bus., Aug. 1974, pt. II, at 7 (table I).

tions owned over 700 major U.S. manufacturing enterprises.[17] There are clear benefits to be derived from receiving more foreign investment, and it has been actively solicited and encouraged in some areas.[18] But with this increase in foreign investment, the United States should also anticipate some of the problems that are likely to arise in dealing with subsidiaries of foreign global corporations.[19] Among these is an increasing difficulty in accurately assessing the impact of foreign-owned subsidiaries on the U.S. balance-of-payments—a particularly troublesome problem in light of the recent increase in the price of foreign oil.

In general, multinational corporations create difficulties for balance-of-payment accounting because of the ambiguities of intercorporate transfers. It is often difficult, if not impossible, to determine whether the prices for intercorporate imports and exports are set to reflect their true value. As a result, it is difficult to determine if a local corporation is being taxed on the full amount of income that is fairly attributable to its operations, or on an amount created artificially through transfer pricing.[20] While the prior focus of the IRS has been on pricing policies of U.S. parent corporations, the recent increase in direct foreign investment means that the U.S. subsidiaries of foreign multinationals will also create transfer pricing problems. Consequently,

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17. R. BARNET & R. MÜLLER, GLOBAL REACH: THE POWER OF THE MULTINATIONAL CORPORATIONS 27 (1974) [hereinafter cited as BARNET & MÜLLER]

18. Among the major benefits are the reduction of the dollar surplus abroad, some offset of the U.S. balance-of-payments deficit (at least with the initial flow of investment), and the possible introduction of new products and technology into the U.S. economy. HEIN, *supra* note 14, at 4.

19. There is a general fear of foreign control over decisions that affect local economic conditions. Moreover, there is concern that the interests of foreign corporate management, which will not be influenced by citizenship ties to the U.S., may be at odds with the best interests of the people of the United States. Note, *The Rising of Reverse Flow, supra* note 3, at 553-56.

Legislation has been proposed in Congress that would limit the percentage of voting securities of any S.E.C.-regulated issuer that could be acquired by noncitizens of the United States. H.R. 11265, 93d Cong., 1st Sess. (1973). The bill is aimed at preventing undesirable social, political and economic consequences of foreign control of U.S. companies, while hoping not to deter foreign portfolio investments.

20. "The tax authorities in the various countries, not having access to all the relevant data in the books of the parent firm and the affiliates, cannot determine their consolidated profits or evaluate the reasonableness of transfer prices." MULTINATIONAL CORPORATIONS IN WORLD DEVELOPMENT 67, U.N. Doc. ST/ECA/190 (1973). *See also,* BARNET & MÜLLER 266-67, in which the authors cite a recent Rand Corporation study as concluding that ". . . because of the widespread use of transfer pricing and the importance of intracorporate transactions in the U.S. economy, Department of Commerce balance-of-payments statistics on foreign trade and foreign-earned income are 'totally unreliable.' " *Id.* at 267.

the tax statutes and administrative regulations that deal with the problem must be applied to the U.S. operations of *both* U.S.-based and foreign-based global corporations; a task to which they may not be equal if competing tax policies are involved.

B. Transfer Pricing and Global Corporate Planning

One of the main goals of global corporate planning is to provide for the free movement of funds among affiliated companies,[21] so that the total corporate global tax bill can be minimized.[22] Subordinating the interests of any particular affiliate to those of the corporate family as a whole, multinationals seek to shift funds so that affiliates in tax-haven areas can be used effectively[23] and the limitations on the U.S. foreign tax credit can be avoided.[24] Moreover, profit figures can be adjusted downward to achieve other subsidiary objectives such as promotion of a favorable corporate public image where a showing of high profits would be politically undesirable.[25]

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21. Having "free movement of funds" means that the global corporation can adjust the accounts of related corporations, shifting and allocating profits and losses among them at will. It does not mean that there will be no costs or tax consequences at all on transfers of funds.

The term "affiliate" refers to any member of the corporate family (parent or subsidiary). The important reality is that all affiliates are owned and managed by the same economic interests.

22. A recent U.S. study concludes that "[i]n a global context, the free movement of funds is the bloodstream of the corporation." Multinational Corporations in World Development, *supra* note 20, at 41.

23. A "tax-haven" area is one that offers comparatively favorable tax treatment—either because of a generally low rate on all income, because of a low rate on foreign income, or because it offers tax holidays to its taxpayers. For example, Grand Cayman Island, a small Caribbean island, is equipped with *ninety-five* different banks and boasts of ". . . complete freedom from all forms of taxation." Quoted in Barnet & Müller 281. A global corporation can set up an "export corporation" on Grand Cayman with nothing more than a desk, a telex cable, and a bank account. Through free movement of funds, the corporation might attempt to show profits on the books of the "export corporation" rather than on the books of its other affiliates, so that the profits would escape taxation when they are "earned." For a general discussion and examples of the effective use of tax havens, see *id.* at 281-83. Guides for the taxpayer on how to use tax havens include: N. Fox, International Tax Haven and Investors Directory (1975); M. Grundy, Tax Havens (3d ed. 1974); Tax Haven Review (N. Fox ed.), a periodical published since 1974 in Copenhagen.

24. The limitation on the U.S. foreign tax credit is directly related to the U.S. taxpayer's foreign source income, so the more income a multinational can shift from domestic to foreign sources, the higher the limitation. Since most payments from affiliates to a U.S. corporation can be structured to create foreign source income for that corporation, free movement of funds allows an upward adjustment of the limitation as needed. *See* note 63 *infra* and accompanying text.

25. Barnet & Müller 159. One of the main criticisms voiced by Latin Americans has been that multinationals repatriate unduly high profits from their Latin American

The payment of dividends from a subsidiary to its shareholder/ parent corporation is only one method, and perhaps not the principal one, of shifting funds. Other methods include transfer payments for royalties, goods purchased from affiliates, interest on loans, rents, and technical-services fees. Because the global management controls both parties to such transfer transactions, the price-determining influence of a market-place is avoided, and prices can be set as high or low as various governmental regulatory agencies will allow.[26] Indeed, a former Treasury official is reported to have said that "[p]rices in an economic sense . . . do not exist" in intercorporate transfers.[27] They are often determined for the primary purpose of shifting funds, not to reflect the fair value of the goods, services, or licenses transferred. Moreover, sophisticated accounting techniques aid multinationals in escaping regulation by confusing or misleading local tax or other authorities.[28] These techniques include undervaluing exports from high tax-rate countries, directing underpriced exports to tax-haven affiliates for resale at fair market value on the open market, and

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operations. *See* Wionczek, *A Latin American View,* in How Latin America Views the U.S. Investor 3 (R. Vernon ed. 1966).

26. Note that this may be true even where a subsidiary is not wholly owned. Managerial control over the business decisions of the affiliates is the key. Even where a global corporation's ownership is phased out, for example, by a Latin American legislative requirement, managerial control may be maintained. An example of the fadeout requirement is the Andean Foreign Investment Code, declaration 7 and art. 28. Decision 24, Commission of the Cartagena Agreement, adopted Dec. 31, 1970, amended by Decision 37 of June 24, 1971 and Decision 37-A of July 17, 1971, 11 Int'l Legal Mat'ls 126 (1972) [hereinafter cited as Andean Foreign Investment Code].

27. Barnet & Müller 277.

28. Barnet and Müller state:

> The institutional lag that cripples governments in their efforts to prevent global corporations from circumventing the spirit of tax, securities, and banking laws is due in no small measure to the technological breakthroughs of the accounting industry. . . .
>
> Skilled obfuscation is now an essential accounting tool. The challenge is to create a tidy world for investors, regulatory agencies, and tax collectors to scrutinize, which may have little or no resemblance to what an old-fashioned bookkeeper might have called the real world. Indeed, it is often desirable to create a different world for each.

Id. at 263.

Documentation of specific examples of artificial transfer pricing is difficult, since corporate books are not publicly available, but impressive studies have been made nonetheless. *See, e.g.,* C. Vaitsos, Comercialización de Technología en el Pacto Andino 117-24 (Instituto de Estudios Peruanos, 1973); Lall, *Pricing by Multinational Manufacturing Firms,* Oxford Bull. of Econ. and Statistics, Aug. 1973, at 173; Vaitsos, *Transfer of Resources and Preservation of Monopoly Rents,* Development Advisory Service: Economic Development Report 168 (1970). *See* Barnet & Müller 158-61, and the other studies on transfer pricing which they cite at 411.

overpricing imports into high tax areas.[29] Flexibility in shifting funds can also be achieved by varying the transfer prices of goods, services, or royalty rates. As one corporate executive has reportedly remarked: "The best way to bring money back varies with the situation. . . . We call the payments whatever seems best under the circumstances."[30]

One of the most common and most flexible methods of shifting funds is through the pricing of royalties and related sevices.[31] Many times companies view royalty and technical-services fees as completely interchangeable,[32] while at other times companies repatriate funds only through inflated prices for goods transferred, and do not make royalty or technical-services charges at all.[33] Sometimes higher royalty charges are desirable, while at other times higher technical-services fees are preferable, depending on the local tax treatment of each.

Royalty payments to affiliates for licenses generally meet with approval from the local government of the transferee, since licenses often bring desirable new technology into the country.[34] Since royalty pricing

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29. BARNET & MÜLLER 157-59. Crawford, *Transfer Pricing in International Transactions*, 1974 MULTINAT'L BUS. No. 3, at 1.

30. *Quoted in* M. DUERR, TAX ALLOCATIONS AND INTERNATIONAL BUSINESS 32 (1972) (A Research Report from The Conference Board).

31. "Related services" refers to services rendered in connection with the intangible, such as consultant or management assistance that contributes to effective use of the license. The term "royalties" will generally be used to include any "related services." "Technical services fees," as used herein, will refer to services not related to licenses and royalties.

32. M. DUERR, *supra* note 30, at 40.

33. *Id.* at 32-33. Section 482 governs the U.S. treatment not only of the use of royalties, but of technical services fees or inflated prices for goods, although the regulations for each are different. *See* notes 48 and 49 *infra* and accompanying text.

34. Many nations, however, particularly in Latin America, are now questioning the value of receiving new technology as an end in itself. Besides the problem of overpricing, some nations have found that transferred technology contributes to capital-intensive industries and does nothing to create new jobs for their nationals. Strings attached to license contracts, especially those that bind the transferee to purchasing future services and goods from the transferor, are seen as hindering the development of indigenous technology. Other transfer agreements may prohibit the export of goods produced with the transferred rights, and these are seen as dooming less developed nations to endless balance-of-payments deficits. *See* Gordon, *The Contemporary Mexican Approach to Growth with Foreign Investment: Controlled but Participatory Democracy*, 10 CALIF. W. L. REV. 1 (1973); *CACTAL Sets Strategy for Science and Technology*, 24 AMERICAS No. 8, at 44 (1972); *Program for the Application of Science and Technology to Latin American Development*, 24 AMERICAS No. 10 (Supp. 1972).

Many nations have responded with statutes limiting the terms of technology transfers. *See, e.g.*, Andean Foreign Investment Code, arts. 18-26, *supra* note 26. *See* Lacey, *Technology and Industrial Property Licensing in Latin America: A Legislative Revolution*, 6 INT'L LAWYER 388 (1972).

In cases where the foreign investor is from a less-industrialized nation (e.g., a petrodollar investor) there may be no technology to transfer legitimately, and the use of royalty pricing may be unrealistic. *See* note 40 *infra*.

is used by multinationals to shift funds, however, the royalty fees may bear no relation at all to the value of the technology transferred,[35] and it is very difficult for local authorities to estimate the true value of the licenses involved.[36] Whereas prices set on the transfer of certain goods can be evaluated by comparing prices charged to affiliates with prices on the open market,[37] a package of intangibles (such as licenses and related services) is harder to scrutinize, since the needs of any particular transferee (i.e., affiliate) may be unique. In such an inter-corporate context, there is no real open market price with which the transfer price can be compared. Therefore, the royalty transfer price mechanism is an especially attractive means for global corporations to clothe the transfer of funds in a legitimate guise, though in fact shifting them principally to avoid taxation.

C. The U.S. Problem with Royalty Pricing

In dealing with artificial royalty pricing, the U.S. tax authorities have focused primarily on cases in which a U.S.-based multinational has granted a license to a foreign affiliate at a very low price. In such cases, the obvious intent of the domestic parent is to undervalue the intangible for export, thereby reducing taxable income in the U.S. in favor of increasing the income of the affiliated recipient abroad. In fact, in a Treasury department study of international cases in which IRS agents had recommended section 482 allocations,[38] it was found that in 73 percent of the cases involving intangibles, *no* consideration at all had been charged by the U.S. taxpayer/licensor to the related foreign licensee.[39]

The current growth of foreign direct investment in the United States is likely to create another kind of problem with royalty pricing: a

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35. The fact that royalty charges often bear no relation at all to the value of actually transferred technology is clear to authors who have examined them. Multinational Corporations in World Development, *supra* note 20, at 49-52; M. Duerr, *supra* note 30, at 32-33. "Managers of global-corporation subsidiaries operating in Latin America whom we have interviewed admit that overvaluing of technology is 'standard practice.'" Barnet & Müller 165.

36. *See* note 28 *supra*.

37. This was the method used by Vaitsos and Lall in their studies, *supra* note 28.

38. Discussion of the mechanics of section 482 begins at note 45 *infra* and accompanying text.

39. *Summary Study of International Cases Involving Section 482 of the Internal Revenue Code*, Department of the Treasury News, Jan. 8, 1973, at 25 (GPO 940-909) [hereinafter cited as *Summary Study*].

foreign-controlled U.S. taxpayer *over*valuing the *import* of an intangible. By charging a U.S. subsidiary an artificially high royalty price, a foreign multinational parent could reduce the U.S. affiliate's taxable income in favor of increasing the income of a related company in a country with lower tax-rates.[40] The potential implications of this possibility are significant: the level of payments for royalties and fees[41] from U.S. companies to related foreign firms was $208 million in 1973, a 34 percent increase over the 1972 level, and a 76 percent increase since 1971.[42] Moreover, royalties and fees represent a fairly substantial factor in the total outflow of funds related to direct investment.[43] In 1972, for example, 18.4 percent of the total outflow of $841 million was in the form of payments for royalties and fees.[44] In light of these considerations it is clear that the United States must now cope with the dual aspects of the royalty transfer pricing problem.

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40. Almost all of the current foreign direct investment in the United States is from countries whose corporations legitimately might have technology to sell to U.S. subsidiaries, and whose accountants certainly understand highly sophisticated accounting techniques. By 1973, 95.4 percent of foreign investment in the United States was owned by interests in the United Kingdom, Canada, and the European Economic Community nations. HEIN, *supra* note 14, at 2.

The inflow of petrodollars has probably changed this distribution, however, and there is some question as to how much "technology" is held by interests in some of the less-industrialized countries that could be legitimately licensed to U.S. affiliates. If petrodollars are invested indirectly (portfolio investments), or are invested in real estate, they will not affect global transfer pricing schemes. On the other hand, petrodollar investment in non-U.S. global corporations might very well encourage more U.S. subsidiary corporations and more transfer pricing activity. Further, petrodollars might be invested directly in intangible property rights which could be leased to others.

41. The U.S. Department of Commerce statistics do not distinguish royalties and related fees from technical service fees in the line item "fees and royalties." *See, e.g.*, SURVEY OF CURRENT BUS., Sept. 1974, at 42, table 2, lines 7, 8, 21 and 22. *See also* note 31, *supra.* Given the fact that many companies use the categories interchangeably, however (*see* note 32 *supra* and accompanying text), this failure is not significant.

42. SURVEY OF CURRENT BUS., Aug. 1974, pt. II, at 9, table 5. Repatriation using royalties has recently increased at a faster rate than the increase in foreign direct investment: the $17,748 million in the United States at the end of 1973 represented a 24 percent increase over the 1972 level and a 30 percent increase since 1971. *Id.* at 7, table 1.

43. Note, however, that the flow of royalties and fees into the United States from foreign affiliates is still much higher ($2.8 billion in 1973) than this outflow. Freidlin & Lupo, *U.S. Direct Investments Abroad in 1973*, *id.* at 11, table 2, line 20. Nevertheless, at a time when all elements of the net U.S. balance-of-payments are important, an outflow of $208 million should be examined carefully.

44. Leftwich, *Foreign Direct Investment in the United States in 1973*, *id.* at 8, table 3. Of the $841 million that left the United States as return on investment in 1972, 34.7 percent left in the form of branch earnings (from unincorporated affiliates), 44.4 percent in dividends, 2.5 percent in interest payments, and 18.4 percent in royalties and fees. In the same year, $496 million of the U.S. earnings were reinvested in the United States.

II

SECTION 482 OF THE INTERNAL REVENUE CODE

A. THE "ARM'S LENGTH" TEST

The administrative authority to deal with the problem of artificial royalty payments is contained in section 482 of the Internal Revenue Code:

> § 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS
>
> In any case of 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, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

This broad grant of administrative power is clearly sufficient to justify IRS action in any case of artificial pricing.[45] Problems have arisen, however, when the IRS has attempted to define standards for determining transfer prices that clearly reflect taxable income.

The current Treasury Regulations accompanying section 482 require that transactions between entities that are controlled by the same interests be made "at an arm's length"[46]—i.e., as if between independent, unrelated parties of equal bargaining power. Section 1.482-2 of the regulations describes tests for an arm's length transaction in a variety of contexts,[47] among them transactions involving royalty transfers. Although royalties for the transfer or use of intangibles[48] are generally treated separately from charges for the performance of services,[49] services rendered in connection with the transfer of intangibles are treated together with the royalty for the intangibles, and no separate allocation by the IRS can be made.[50]

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45. A heavy burden is on the taxpayer to show abuse of administrative discretion—that the IRS was "arbitrary and capricious"—in order to nullify an IRS reallocation. Pauline W. Ach, 42 T.C. 114, 126 (1964), *aff'd* 358 F.2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966). The burden is even greater in a refund case, where the taxpayer must additionally prove what the correct allocation should have been. Helvering v. Taylor, 293 U.S. 507 (1935); United States v. Pfister, 205 F.2d 538 (8th Cir. 1953).

46. Treas. Reg. § 1.482-2 (1968).

47. The regulations describe different tests for an arm's length dealing where services are performed, where tangible property is used, where intangible property is used or transferred, and where tangible property is sold. Treas. Reg. § 1.482-2 (1968) (as amended).

48. Treas. Reg. § 1.482-2(d) (1968) (as amended).

49. Treas. Reg. § 1.482-2(b) (1968) (as amended).

50. Treas. Reg. § 1.482-2(b)(8) (1968) (as amended).

The greatest problem with the present tests arises when no similar transactions can be found between unrelated parties; precisely the situation likely to arise in corporate transfers, which by their very nature, are likely to be transactions that frequently no unrelated parties would ever enter into. If no sufficiently similar situations can be found, the regulations list twelve factors upon which the IRS can rely to determine an artificial arm's length price.[51] But the list raises more questions than it answers, because there is no requirement that any or all of the factors actually be considered, and there is no indication of the relative weight to be ascribed to the various factors.[52] No concrete tests emerge, resulting in vague standards which are difficult to apply.

B. Application of the Arm's Length Standard

As mentioned above, section 482 has been used in the area of royalty pricing predominantly to correct prices, charged by a U.S. company to a foreign affiliate, that the IRS has found to be set at less than an arm's length level.[53] The reverse situation, in which a foreign transferor has charged a related U.S. taxpayer royalty rates that the IRS might find to be higher than an arm's length price, has apparently received little attention, official or otherwise. A study by the Conference Board refers to but one such situation. In that case, the IRS disallowed an entire royalty payment to a foreign parent, claiming that there was no justification for the payment, and taxed it as a dividend.[54]

In general, U.S. taxpayers have found it hard to comply with the arm's length standard because they cannot predict with any certainty how the IRS will treat their transfers.[55] In cases in which companies

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51. Treas. Reg. § 1.482-2(d)(2)(iii) (1968) (as amended).

52. For a discussion of some of the problems with 1.482-2(d), see Note, *Application of Section 482 to the Transfer or Use of Intangible Property,* 17 U.C.L.A. L. Rev. 202 (1969). *See also* Bischel, *Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal,* 13 Va. J. Int'l L. 490 (1973).

53. *Summary Study supra* note 39, at 25. Of all international cases covered by the IRS study of the use of section 482, 10 percent of the adjustments made were in the area of allocations on royalties paid for intangibles. *Id.* at 16. The amount of the adjustments made regarding intangibles (in a two-year period during the late sixties) was $52.4 million, about 8 percent of the total. *Id.* at 19. The average amount per adjustment made regarding the transfer of intangibles was $524,000. *Id.* at 20. The study uses "per adjustment" to include all adjustments of a given category made for a single U.S. taxpayer in a single year.

54. M. Duerr, *supra* note 30, at 33-34. The foreign parent objected, claiming it had paid a premium over book value for the license when it bought the U.S. subsidiary, and an appeal through tax treaty channels was under way when the study was published.

55. One of the main reasons that The Conference Board, a business research organization, undertook the Duerr study, *id.,* was to document and articulate the problems that

have had no intent to effect a shift of funds among affiliates, they have gone out of their way to set prices based on what they hoped would satisfy the IRS auditor or foreign tax authorities.[56] Business experience seems to indicate that section 482 allocations on royalty charges are often considered on a case by case basis, without the application of consistent underlying principles, and that many bargained settlements with the IRS auditors have resulted in pricing that bears no relation to the true value of the license whatsoever.[57]

Everyone would benefit from a clearer definition of the test for an arm's length transaction. Not only would the administrative task of the IRS be facilitated, but corporations could plan with greater certainty.[58] Moreover, it is entirely possible that useful foreign investment is now deterred from entering this country because of the uncertainty and ambiguity of IRS treatment of intercorporate transfers.[59] But the task of establishing better standards has been made more difficult by the emerging need to deal with both U.S. licensors and licensees. In the absence of a clear test applicable to all cases, the definition of minimal safe-haven areas would be helpful.[60] The recently proposed Treasury regulation 1.861-8 offers a possible safe-haven area for minimal rates that a foreign multinational could legitimately charge a U.S. affiliate.[61]

III

PROPOSED TREASURY REGULATION 1.861-8

A. The Logic of Regulation 1.861-8

Sections 861-863 of the Internal Revenue Code define income from sources within and without the United States for various tax purposes.[62] Appropriate expenses and deductions attributable to each

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U.S. multinationals were having with § 482. The study was financed by forty-six corporations, all associates of The Conference Board.

56. *Id.* at 32.

57. *Id.* at 32-39.

58. Corporate planning is especially difficult because audits may require allocations years after the transactions took place.

59. The IRS disallowance of an entire royalty payment shortly after a foreign parent had paid a premium for the license rights, *supra* note 54 and accompanying text, would certainly be cause for concern among potential foreign investors.

60. "Safe-haven" area is defined in note 13 *supra.*

61. *See* Bischel, *supra* note 52, at 511. M. Duerr, *supra* note 30, at 79-93, makes some other suggestions for the improvement of the section 482 allocation system.

62. The source-of-income rules are applicable to the limitations on the foreign tax credit (§§ 904(a)(1) and (2)), the DISC intercompany pricing rules (§ 994), "effectively connected" taxable income (§§ 871 and 882), foreign base company income (§ 954(b)(5)), and income partly from within and partly from without the U.S. (§ 863(b)).

category of income are considered in arriving at taxable domestic source income and taxable foreign source income. The source-of-income distinction is important because the limitation on the foreign tax credit is based on the proportion of taxable foreign source income to total taxable income.[63]

Proposed regulation section 1.861-8 describes methods for allocating and apportioning expenses, losses, and other deductions between domestic source and foreign source income.[64] Section 1.861-8 (e)(3) deals specifically with research and experimental expenditures.[65] It

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63. INT. REV. CODE of 1954, § 905. For a taxpayer electing the overall limitation:

$$\text{foreign tax credit limitation} = \text{tentative U.S. tax (before credit)} \times \frac{\text{taxable foreign source income}}{\text{taxable income from all sources}}$$

If the "per country" method is used, taxable income from a particular country or U.S. possession is substituted for taxable foreign source income to arrive at the limitation for that country. For a good explanation of how the credit works, and the extent of its use, see SUPPLEMENTAL STATISTICS OF INCOME 1964, 1965, AND 1966: FOREIGN INCOME AND TAXES 4-19 (Internal Revenue Service Publication No. 479 (4-73), 1973).

64. Prop. Treas. Reg. § 1.861-8. Deductions are first *allocated* to a specific class of income, when they are "definitely related" to that class, i.e., when they are incurred as a result of or incident to an activity (or in connection with property) which can reasonably be expected to generate income (e.g., of a class of income: income generated from the sale of a certain product and income generated from the sale of an intangible property license). Some deductions may be related to more than one specific class, and they must be allocated to a larger class which encompasses the other classes (e.g., general administrative costs might be allocated to "all gross income" as a class). Some deductions are not definitely related to any gross income at all, such as charitable contributions, or the costs of compiling an annual shareholder's report. Prop. Treas. Reg. §§ 1.861-8(c)(2) and (e)(9).

As a second step, income within a specific class is *apportioned* among statutory groupings and/or residual gross income. A class of income may be included in more than one statutory grouping. An example of a statutory grouping is foreign source income where the overall foreign tax credit limitation is elected. Where the per-country limitation is used, foreign source income from each foreign country or U.S. possession comprises a separate statutory grouping. Prop. Treas. Reg. §§ 1.861-8(a) and (b). Residual gross income is income which does not need to be separated out of all gross income for the purposes of determining taxable income from some specific source or activity under an operative provision of the I.R.C. *See* Prop. Treas. Reg. § 1.861-8(a)(3). Deductions that are not definitely related to gross income are also apportioned among statutory groupings. Prop. Treas. Reg. §§ 1.861-8(c)(2) and (e)(9).

In terms of the considerations of this Note, the amounts of deductions that end up in various statutory groups or residual gross income are crucial, because they determine the extent to which a taxpayer will get credit for income taxes paid to foreign governments on its U.S. tax bill (i.e., they determine the limitations on the foreign tax credit).

65. Prop. Treas. Reg. § 1.861-8(e)(3):

> *Research and experimental expenditures*—(i) Allocation.—Expenditures for research and development which a taxpayer deducts under section 174 shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class. Where research and development is intended to create, or is reasonably expected to result in the

addresses the situation in which a U.S. taxpayer realizes income of disparate types, as, for example, when he carries on research to improve a product or increase sales of the product and earns both domestic income from the sales of the product, and foreign source income from royalties charged to a foreign company (whether or not affiliated) for licenses giving it the right to sell the product abroad. The research undertaken is of potential benefit to both the taxpayer and the licensee, but the expense is currently incurred only by the U.S. taxpayer/licensor. Section 861 requires that the U.S. taxpayer apportion his research deduction between domestic income (from domestic sales of the product related to the research) and foreign source income (from the royalty charge to the licensee). Subsection 1.861-8(e)(3)(ii) stipulates that:

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creation of, specific intangible properties or processes, or is intended or is reasonably expected to result in the improvement of specific properties or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably expected to give rise. Experience in the past with research and development shall be considered in determining reasonable expectations. In other cases, as in the case of most basic research, research and development shall generally be considered definitely related and therefore allocable to all gross income of the current taxable year which is likely to benefit from the research and development. The gross income of the current taxable year which can be reasonably assumed to have benefitted from similar research and development in the past is ordinarily acceptable as an indication of likely benefits from current research and development. The types of gross income to which deductions for research and development expenses are generally allocable include, but are not limited to, gross income from:

(A) The sale or rental of tangible property or the performance of services with respect to which intangible property is used,

(B) The lump-sum sale of intangible property,

(C) The licensing or other use of intangible property, and

(D) The receipt of dividends from a corporation the stock of which was acquired for intangible property in a tax-free exchange or from a corporation to which intangible property was transferred as a contribution to capital.

(ii) *Apportionment.* If the gross income resulting from research and development activity is or is reasonably expected to be of disparate types, such as sales income and royalty income, apportionment of the deductions for research and development expenses allocated thereto on such basis as gross income or gross receipts will not generally be reasonable.

(iii) *Examples.* Reasonable methods of allocation and apportionment are illustrated by examples (1) and (10) through (13) of paragraph (g) of this section. It should be noted that the methods of allocation and apportionment illustrated by these examples may not be appropriate in any case where important distinguishing factors are present. For instance, some of the examples use units as a basis for apportionment of research and development expenses. Nonetheless, if a research activity benefits two or more products with dissimilar characteristics (such as jet airplane tires and bicycle tires), apportionment on the basis of units may create distortions and, therefore, would be inappropriate.

> If the gross income resulting from research and development activity is or is reasonably expected to be of disparate types, such as sales income and royalty income, apportionment of the deductions for research and development expenses allocated thereto on such basis as gross income or gross receipts will *not* generally be reasonable.[66]

Since the research expenses cannot be apportioned according to the U.S. taxpayer's gross income from domestic sales and from royalty fees, an alternative basis for apportionment is needed. Example 12 of regulation 1.861-8(g) suggests that unit sales would be appropriate for this purpose, in the absence of an indication that current unit sales are not a reasonable basis for estimating future unit sales. In other words, the cost of research that may improve a product or benefit future sales should be allocated between domestic income and foreign source income, based on current unit sales of the product in the United States and abroad, even though units sold abroad are sold by the transferee, not by the U.S. taxpayer. The actual income to the transferor from its foreign source is irrelevant to the apportionment of the research deduction.

This method of apportionment is a substantial inducement for the U.S. taxpayer to recover from the licensee that portion of the expenses that are fairly attributable to the licensee's unit sales, plus an amount at least sufficient to pay foreign withholding taxes on the royalty fee to the licensor.[67] In the situation considered here, the only way to ac-

66. Prop. Treas. Reg. § 1.861-8(e)(3)(ii) (emphasis added).

67. For example, suppose a domestic corporation, *P*, sells 75,000 units of X at $10/unit, and spends $60,000 on research and development to improve X. *P* licenses the rights to manufacture and sell X abroad to *S*, a wholly owned subsidiary, which sells 25,000 units at $10 and pays a royalty to *P* of 4 percent of its gross sales ($10,000). Suppose *S*'s nation taxes *P* on the royalty payment at a rate of 30 percent ($3,000), and *S*'s income from X is taxed at 48 percent in the United States. Assume *P* has deductions of $650,000 on X (for "R & D," cost of goods sold, overhead and management expense, etc.). Then:

10,000	foreign source income (FSI) from royalty
+ 750,000	domestic source income (DSI) from sales of X
760,000	U.S. gross income (GI) on X
− 650,000	deductions (ded.) (including "R & D")
110,000	U.S. taxable income (USTI)
52,800	tentative U.S. tax at 48% (ten. US tax)

A) Basing its apportionment of "R & D" expense on gross income to *P*, the amount apportioned to *P*'s foreign source income would be:

$$\frac{10{,}000\ (\text{FSI})}{760{,}000\ (\text{GI})} \times 60{,}000\ (\text{ded.}) = 789$$

Therefore:

10,000	FSI
− 789	FS ded.
9,211	FSTI

complish this is to adjust the royalty charges so that the U.S. taxpayer's actual foreign source income is at least as great as these amounts. If the

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And the limitation on *P*'s foreign tax credit, (FTC lim), (*see* note 63 *supra*) would be:

$$\text{FTC lim} = 52{,}800\ (\text{ten. US tax}) \times \frac{9{,}211\ (\text{FSTI})}{110{,}000\ (\text{USTI})} = 4421$$

All of the $3,000 paid to *S*'s nation (30% of $10,000) would be credited to *P*'s U.S. tax bill, since that sum is less than FTC lim.

B) Prop. Treas. Reg. § 1.861-8 would prohibit an apportionment based on gross income, however, and 1.861-8(g) (example 12) suggests using unit sales as a basis for apportionment. The amount of *P*'s "R & D" deduction apportioned to foreign source income would then be:

$$\frac{250{,}000\ (S\text{'s units sold})}{1{,}000{,}000\ (\text{total units sold})} \times 60{,}000\ (\text{ded.}) = 15{,}000$$

So:

$$\begin{array}{rl} & 10{,}000\ \text{FSI} \\ - & \underline{15{,}000}\ \text{FS ded.} \\ & \text{zero}\ \text{FSTI} \end{array}$$

And:

$$\text{FTC lim} = 52{,}800 \times \frac{0}{110{,}000} = \text{zero}$$

In other words, none of the $3,000 paid to *S*'s nation would be credited, and after paying the 48 percent tax on the royalty to the United States ($4800), *P* would have paid a total of $7,800 on the $10,000 royalty (an effective tax rate of 78 percent).

C) The only way for *P* to avoid this double taxation and high effective rate is to increase the royalty charge until it covers the "R & D" deduction apportioned to *P*'s foreign source income and the foreign tax as well. The result is a royalty charge of $40,000 instead of $10,000 (and a payment of a 30 percent tax or $12,000 to *S*'s nation). Now:

$$\begin{array}{rl} & 40{,}000\ \text{FSI} \\ + & \underline{750{,}000}\ \text{DSI} \\ & 790{,}000\ \text{GI} \\ - & \underline{650{,}000}\ \text{ded.} \\ & 140{,}000\ \text{USTI} \\ & \\ & 67{,}520\ \text{ten. US tax} \end{array} \qquad \text{apportioned FS ded.} = 15{,}000\ (\text{as above})$$

So:

$$\begin{array}{rl} & 40{,}000\ \text{FSI} \\ - & \underline{15{,}000}\ \text{FS ded.} \\ & 25{,}000\ \text{FSTI} \end{array}$$

And:

$$\text{FTC lim} = 67{,}200 \times \frac{25{,}000}{140{,}000} = 12{,}000$$

All $12,000 paid to *S*'s nation would be credited to the U.S. tax bill, and *P*'s total tax would be $19,200 on a royalty of $40,000:

$$\begin{array}{rrl} 40{,}000 \times .48\ (\text{US rate}) = & & 19{,}200\ \text{ten. US tax} \\ & - & \underline{12{,}000}\ \text{FTC} \\ & & 7{,}200\ \text{US tax} \\ & + & \underline{12{,}000}\ \text{tax to } S\text{'s nation} \\ & & 19{,}200\ \text{total tax (a 48\% rate)} \end{array}$$

royalty charges are less than what is necessary to produce such a result, the U.S. taxpayer will have a foreign source deduction that exceeds its foreign source income, so that its taxable foreign source income will be zero.[68] As a consequence, the limitation on its foreign tax credit would be zero, and any taxes paid abroad on the royalty income could not be credited to its U.S. tax bill. Thus it appears that the net effect of the proposed regulation on royalty charges would be to force a U.S. licensor either to forego a foreign tax credit (unless it can spread the deduction to other nations under the overall limitation) or charge royalty fees that represent at least that portion of ongoing research costs which the foreign unit sales of the licensee currently bear to total worldwide unit sales of the related product (plus enough to pay any foreign or state taxes on the royalty income).[69]

In cases where the IRS felt that U.S. companies were transferring licenses or other intangibles at artificially low prices, the provisions of the new regulation would frequently force the prices up, and without the use of section 482 and its necessary audits and remedial action, the U.S. transferor's domestic taxable income would be increased. The logic of section 1.861-8 provides a straightforward and easily applied formula for all licensors as to how high royalty rates would have to be to offset the licensee's share of research and development expenses.

B. The Implications of Section 1.861-8

The policy motivation underlying proposed regulation 1.861-8 is a desire to limit the use of deduction allocations as a mechanism for effectively shifting funds from U.S. parent companies to foreign sub-

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In the context of the global corporation, this royalty increase means that *S*'s income is decreased in favor of *P*'s income. If the tax rate on *S*'s income (imposed by its own nation) is less than the U.S. tax rate of 48 percent on *P*'s income, then global management would have to weigh the tax "savings" due to the reduction in the effective U.S. tax rate on the royalty payment against any tax savings foregone due to the reduction of *S*'s income in favor of *P*. The tax rate on *S*'s income would determine the optimal royalty transfer price.

68. Under the proposed system, it is possible for a taxpayer to have foreign source deductions greater than its foreign source income. Prop. Treas. Reg. § 1.861-8(d).

69. However, some U.S. licensors may have enough other foreign source income, and even enough per-country foreign source income, that they can keep the foreign tax credit limitation sufficiently high. In these cases, the effect would be perhaps only to cause a reexamination of tax strategy on whether to elect a per-country or an overall limitation. The amount of other transactions and the relative rates charged by the foreign tax collectors would help determine how much the regulation would affect a given taxpayer.

sidiaries.[70] The IRS feels that United States-based multinationals are allocating an unreasonably large portion of their research and development costs to domestic sales income, when in fact the product technology created is greatly enhancing sales income abroad as well. This practice is, in effect, a royalty transfer pricing mechanism, since multinationals are transferring the benefits of the product technology without charging sufficiently high royalty fees to receive a reasonable portion of the costs of creating the product technology in return.[71] The regulation attempts to outline a reasonable basis for allocating research and development expenses so that the "R & D" deduction is fairly matched with *all* of the income generated by the expenditure.[72]

It must be remembered, however, that the principles and regulations that deal with intercorporate royalty pricing must be applied to *both* U.S. and foreign-based global corporations. If proposed regulation 1.861-8 tends to force royalty prices for U.S. transferors upward, consistency demands that it should do the same for U.S. transferees. If certain ongoing research expenditures are properly attributable to foreign licensees based on the percentage of worldwide sales represented by licensee sales, then foreign licensors should fairly be able to base their royalty fees on the same grounds.[73] Thus, as a first step toward a safe-haven minimum price, the foreign licensor could immediately figure in that portion of its research and development expenses that are fairly attributable to the licensee's unit sales as a proportion of worldwide unit sales. Provisions of the regulation point

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70. *See* Cole, *Highlights of the Proposed Regulations on Allocation and Apportionment of Deductions,* 39 J. TAXATION 272-74 (1973); Tannenbaum, *Limiting the Foreign Tax Credit: Treasury Trying to Stiffen Vital Deduction Allocation Rules,* 2 TAX NOTES No. 2, Jan. 14, 1974, at 12.

71. The practice has a double benefit to global corporations. It not only gives a foreign subsidiary product technology at bargain prices, but it also keeps the U.S. parent's foreign tax credit limitation high by not deducting the proportionate cost of creating the technology from foreign source income. *See* note 63 *supra.*

72. The problem is one of the present deduction allocation of future benefits. Section 174 of the Internal Revenue Code allows a current deduction for "R & D" but conceptually, the amortization of "R & D" costs over several years makes more sense. "Given this inherent mismatching of R & D expense and income, . . . the proposed regulations are a reasonable, though admittedly imperfect, solution to an issue incapable of a perfect solution." Ira Tannenbaum, quoted in *TA/A Analysis Supports IRS Authority for Deduction Allocation Rules,* 2 TAX NOTES No. 48, Dec. 2, 1974, at 10.

73. In the case of U.S. branch operations of foreign companies, the analysis is the same. A portion of the overall research and development costs can be attributed and apportioned to the gross income of the U.S. branch based on the branch's unit sales. In this situation there are no royalty fees paid and no licenses granted, but by apportioning deductions, the taxable income of the U.S. branch is reduced in a way similar to the subsidiary situation.

out that research costs are commonly the principal factor in generating royalty income; it is clear, therefore, that they are "definitely related" to royalty income.[74]

This first step may be an especially advantageous one for a foreign licensor seeking to justify high royalty charges to a U.S. affiliate. Two of the major reasons for setting up operations in the United States are to obtain access to the large and wealthy U.S. market, and to export from the United States to areas that could not be served as economically from the corporation's home country.[75] Both of these indicate that U.S. unit sales are likely to be relatively high, which in turn justifies the reflection of a high percentage of research and development costs in royalty prices.

This "R & D" element in setting a foreign licensor's royalty fee is, however, only a first step. Section 1.861-8 informs U.S. taxpayers generally that *actual* income from foreign sources must exceed deductions attributable to them in order to qualify for a foreign tax credit. The underlying rationale of this rule applies logically to *any* licensor (foreign or domestic). The method suggested by the regulation requires a licensor to examine its own expenses (deductions) and, using the outlined allocation and apportionment rules, charge the licensee a royalty fee that exceeds the apportioned share of those expenses attributed to the royalty income. This methodology can be extended to other expenses besides those for research and development.

The obvious next step is a "tax element." The licensor must pay taxes on the royalty payment, including often an income tax levied by the transferee's jurisdiction (on income earned therein by the licensor), and possibly including a national and/or local tax imposed by the transferor's taxing jurisdictions.[76] Expenditures for income taxes are obviously allocable to the income on which the taxes are imposed. In terms of a deduction apportionable to foreign source income, the "tax element" would be that part of a U.S. taxpayer's section 164 deduction which is due to (i.e., definitely related to) royalty income from a foreign

74. Prop. Treas. Reg. § 1.861-8(c)(vi): "[R]esearch activity will normally be the principal factor in the generation of the royalty income. . . ."

75. HEIN, *supra* note 14, at 2.

76. Tax treaties are likely to reduce taxes imposed by the transferee nation and/or the transferor's nation. For example, the 30 percent U.S. withholding tax on royalty payments to foreigners might be reduced to as little as 5 percent by an applicable tax treaty. While the U.S. foreign tax credit works to prevent double international taxation, state or local income taxes on payments into the United States may still apply.

source.[77] This element of the royalty charge is greater than the tax rate times the rest of the royalty fee, since the tax rate applies to the total payment made by the licensee, including the initial charge plus the tax. Further, payment must be sufficiently greater than the allocable deductions to ensure that foreign taxable income allows a limitation on the foreign tax credit that is high enough to cover the taxes paid to the licensee's government.[78] The licensor must set the "tax element" high enough so that the after-tax receipt will cover the "R & D" element and whatever other elements the licensor can justify.

A third element to add to a royalty fee might be found in the licensor's expenses that are "not definitely related to any gross income." Proposed section 1.861-8(c)(2) provides that such deductions (expenses) "must be apportioned ratably between statutory groupings," and the apportioned share to each grouping "shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount or gross income." Section 1.861-8(e)(9) lists examples of deductions not definitely related to any gross income, including such things as charitable contributions and general expenses incurred in dealing with shareholders.[79] While such expenses are clearly not connected with producing royalty income, they are not connected with any other income either, and so their deductions are ratably apportioned.

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77. Prop. Treas. Reg. § 1.861-8(e)(6) covers income taxes specifically. Section 164 of the Internal Revenue Code allows a deduction for certain taxes paid or accrued during the taxable year.

78. *See, e.g.*, note 67 *supra*. Because of the "gross-up" phenomenon, the licensee cannot simply pay the licensor's tax bill, at least where the licensor is in the United States. This would increase the licensor's gross income and subject him to a higher tax, reflecting the amount of the first tax payment, which it effectively received as additional consideration for the license. Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

79. Prop. Treas. Reg. § 1.861-8(e)(9):

> *Deductions which are not definitely related.*—Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are—
>
> (i) The deduction for interest allowed only by section 163,
>
> (ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use,
>
> (iii) The deduction for medical expenses allowed by section 233,
>
> (iv) The deduction for charitable contributions allowed by section 170 (but see paragraph (1) of this section in the case of a nonresident alien or foreign corporation engaged in a trade or business in the United States),
>
> (v) The deduction for alimony payments allowed by section 215, and
>
> (vi) The deductions of a corporation for expenses in connection with the issuance of its stock, the preparation of its annual report, or the annual meeting of its shareholders, or otherwise related to its relationship with its shareholders. . . .

Note that some of these deductions are only available to individual taxpayers.

Deductions which are "supportive in nature" (overhead, general or administrative costs, etc.) offer a fourth component in building a high royalty charge. Any overhead or administrative expenses incurred in obtaining and maintaining a licensing contract are clearly deductions allocable and apportionable to the income from the license.[80] In this connection, the "related services" that accompany license rights may be important, since the cost of delivering these services might be relatively easy to identify and to attribute to the royalty. Even after a taxpayer has allocated its supportive expenses to various specific classes of income, there may be "residual" supportive costs which can be attributed to "all gross income" as a class.[81] These deductible costs the taxpayer can freely apportion among statutory groupings, as long as the method used "reflects to a reasonably close extent the factual relationship between the deduction and the gross income."[82] Where income is of "disparate types" (such as royalty income and sales income), it is "generally improper to apportion deductions by comparing amounts of gross income. . . ."[83] It appears difficult, however, to find another means of apportionment that would be acceptable, because any supportive expenses that are genuinely related to the royalty income can be attributed to that income as a class, and the "residual" supportive costs would not include them.[84] Nonetheless, the "support" element in calculating a royalty charge may be significant where the licensor can account for supportive expenses that relate to the license.

A fifth possible means of justifying high royalty rates is with an "interest element." Regulation 1.861-8(e)(2) provides that interest is to be considered allocable to all gross income as a class, since loans, even

80. Under Prop. Treas. Reg. § 1.861-8(c)(1)(v), apportionment is permissible based on "[c]omparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to activities or properties giving rise to the class of gross income. . . ." The "class of gross income" is simply income from the sale of licenses. This "apportionment" reasoning is valid for the "allocation" of these costs to royalty income as a specific class. *See* note 64 *supra.*

81. This possibility is described in Prop. Treas. Reg. § 1.861-8(b)(3).

82. Prop. Treas. Reg. § 1.861-8(c)(1).

83. *Id.* Note that the language used is "generally improper." An exception is expenses that are "not definitely related to any gross income." *See* note 79 *supra* and accompanying text. Prop. Treas. Reg. § 1.861-8(c)(2) requires this exception in its language that such deductions "*must* be apportioned ratably" and that the portions "*shall* be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income." (Emphasis added)

84. In other words, the specific supportive expenses related to the royalty are allocated to the class of "royalty income," and not to the class of "all gross income." The portion of supportive expenses attributable to royalties is entirely accounted for at the *allocation* level; none of the "residual" or general costs allocable to "all gross income" can be *apportioned* to royalty income. *See* note 64 *supra.*

where used for specific income-producing activities, free other funds for other uses. Regulation section 1.861-8(e)(2)(v), however, stipulates that the interest deduction should not be apportioned on the basis of gross income, but on the basis of the amounts of capital invested in various income-producing activities.[85] Since it is highly unlikely that a licensor would have much, if any, capital invested in pursuit of royalty income,[86] this "interest element" is probably not very useful.

Finally, a "profit element" can be added. Any "arm's-length" dealing to establish a royalty charge would probably result in the inclusion of some margin of profit for the licensor above his theoretical cost-recovery level. How wide the profit margin should be is open to question, but some increase in the royalty charge for a profit element seems reasonable.[87]

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85. See the example in Prop. Treas. Reg. § 1.861-8(e)(2)(vi).

86. The relevant question here is how much capital is *invested* in producing intangibles that might be licensed, and how that amount compares with capital invested in other areas. Because section 174 of the Internal Revenue Code allows the option, most taxpayers deduct "R & D" expenses currently rather than amortizing them. As a result, "R & D" costs are not "capital invested." The fact that the intangible produced is a capital asset is not relevant because in the hands of its producer it is not investment capital, but rather similar to inventory.

87. By way of summary, suppose that in the example in note 67 *supra*, *S* were a foreign-based global corporation with *P* a wholly-owned subsidiary in the United States. Assume that the sales breakdown is the same, but that *S* owns the intangible property rights, which are licensed to *P* in the United States. Because the U.S. market is where three-fourths of the sales of X occur, assume that, of *S*'s overhead and administrative costs, $30,000 is spent directly in support of the U.S. operation (services related to the royalty). Also assume that *S* has $10,000 of expenses not definitely related to any gross income (shareholder expenses, charitable contributions, annual report costs). Assume that *S* now carries on "R & D."

If *S* wishes to use a royalty transfer price to shift funds out of the United States, it can meet the arm's length test of Section 482 by using the principles underlying the Prop. Treas. Regs. § 1.861-8. Its justifiable royalty charge could be as high as $121,635, comprised of:

A) "R & D" expense apportioned on the basis of unit sales (three-fourths apportioned to the royalty):

$$60{,}000\ (\text{R\&D}) \times \frac{750{,}000\ (\text{US units sold})}{1{,}000{,}000\ (\text{total units sold})} = 45{,}000$$

B) Expenses not definitely related to any gross income, apportioned based on gross income from the royalty in proportion to all gross income:

$$10{,}000 \times \frac{121{,}635\ (\text{royalty income})}{121{,}635\ (\text{royalty}) + 250{,}000\ (S\text{'s sales})} = 3{,}273$$

C) Supportive expenses directly related to the royalty and service fees for the supervision of U.S. operations: 30,000.

D) A modest profit margin of 5% above recovery of cost (i.e. A + B + C):

$$.05 \times (45{,}000 + 3{,}273 + 30{,}000) = 3{,}914$$

C. SUMMARY

The logic of proposed Treasury Regulation 1.861-8 offers a licensor several possibilities for boosting royalty prices. It legitimizes the use of royalties to set off a potentially large portion of research and development expenses, based on the licensee's unit sales compared with the total worldwide unit sales. Since the value of license rights usually results directly from research and development, this set-off seems reasonable.[88]

Within the reasoning of basing royalty rates on portions of deductions attributable to royalty income, there is room for adding to this "R & D" element substantially. The end result is a package of justifications for a licensor who wishes to transfer extra funds out of the licensee's books.

CONCLUSION

The proposed Treasury Regulation 1.861-8 suggests a method for calculating royalty rates based on expenses of the licensor.[89] The method can be used to justify a safe-haven minimal level for royalty payments that are subject to review under I.R.C. section 482. Because the application of section 482 has been difficult, and well-defined standards for arm's length pricing have been lacking, the regulation may provide a welcome degree of predictability in the enforcement of section 482 in cases where royalty rates are relatively high.

On the other hand, this analysis may cast doubt on the soundness of

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E) A tax element which leaves enough after-tax income to total A + B + C + D:

$$.48 \times (45{,}000 + 3{,}273 + 30{,}000 + 3{,}914) = 39{,}450$$

The total royalty is A + B + C + D + E:

$$45{,}000 + 3{,}273 + 30{,}000 + 3{,}914 + 39{,}450 = 121{,}637$$

$121,637 is rounded off to $121,635.

88. Not surprisingly, corporate executives and their attorneys have disagreed with the view that the set-off is reasonable. *See The Numbers Game: Bringing Home the (Tax) Bacon*, FORBES, Dec. 1, 1974, at 66. *Compare, T/A Analysis Supports IRS Authority for Deduction Allocation Rules, supra* note 72.

89. It seems unlikely that the IRS would use this method to impose high royalties on U.S. licensors, because this would substantially alter current section 482 practices. In the original example, note 67 *supra*, the justified royalty charge, based on an "R&D" element alone, was $40,000 on foreign sales of $250,000—a 16 percent royalty. IRS enforcement practices indicate that royalties of 4-5 percent are usually accepted. M. DUERR, *supra* note 30, at 36-37, 49.

proposed 1.861-8 and the allocation principles outlined therein. From the point of view of a foreign-based multinational corporation, regulation 1.861-8 provides several justifications for charging high royalty rates to affiliates in the United States. Since it is unlikely that the IRS would object to royalty charges that are lower than the suggested safe-haven area, the foreign licensor is left with a flexible means for shifting funds into and out of the United States. In the long run, the benefits of the proposed regulation may not be worth the cost of allowing such flexibility.

As foreign direct investment in the United States increases, the U.S. will have to deal increasingly with foreign multinational corporations which have affiliates here. In trying to prevent artificial transfers of funds out of the United States, section 482 is a powerful and potentially effective tool. But adoption of proposed regulation 1.861-8 may leave, in the area of royalty pricing, a loophole for foreign multinationals that the IRS will not be able to close.

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