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Continuity and Change in the Present and Possible Future Taxation of Cross-Border Intangible Income

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Software engineers develop a patented computer operating system, and the company for which the engineers work generates high profits from selling and licensing the use of the operating system.[1] If the company is a U.S. company and the operating system is sold or licensed only in the United States, it might be easy enough to conclude that all the patent-related sales income should be taxed exclusively in the United States. If, instead, the operating system is developed entirely in the United States but is sold both in the United States and abroad, should the U.S. income measurement question be viewed differently from the situation in which the operating system serves only the U.S. market?

Now consider a more complicated – and also more realistic – scenario. The U.S. company has foreign subsidiaries organized in, among other locations, Ireland, Puerto Rico and Singapore.[2] These subsidiaries pay a portion of the global company's expenditures on research and development related to the operating system. Employees of the Irish, Puerto Rican, and Singaporean subsidiaries perform various functions. For example, employees of one or more foreign subsidiaries contribute to the development of new versions of the operating system, including by tailoring those versions for use in the regions in which the employees perform their work. Employees of the foreign affiliates also are engaged in the production of physical copies of the software. An Irish subsidiary is responsible for selling the operating system (or licensing its use) to customers in

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[1] This example is adapted from two sources: Glenn R. Simpson, *Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe*, WALL ST. J., Nov. 7, 2005, at A1, and *Offshore Profit Shifting and the U.S. Tax Code: Hearing Before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs*, 112th Cong. 19-23 (2012) (exhibit 1a, Memorandum from Permanent Subcommittee on Investigations).

[2] The Internal Revenue Code treats a corporation organized in Puerto Rico or another U.S. territory such as the U.S. Virgin Islands as a foreign corporation. See I.R.C. § 7701(a)(4), (5), and (9) (defining a domestic corporation as a corporation organized in the United States or under U.S. law or the law of any state; defining a foreign corporation as any corporation that is not domestic; and defining the United States as including only the U.S. states and the District of Columbia).

Europe, the Middle East, and Africa. A Puerto Rican subsidiary has similar responsibilities for customers in North America and South America, and a Singporean subsidiary performs sales and licensing functions for Asian customers. The Irish, Puerto Rican, and Singaporean subsidiaries carry out their sales and licensing functions by contracting with local distributors in the respective regions. Some local distributors are affiliated with, and other local distributors are unaffiliated with, the U.S.-headed company.

Under these more complicated facts, the United States understandably might assert jurisdiction to tax some portion of the foreign sales income attributable to the operating system patents because, among other reasons, U.S. research created the patents and is responsible for a significant portion of changes to the operating system when the company releases new versions of the software. But would it be reasonable for the United States to argue that it should have primary taxing rights over all income attributable to older and newer patents even though some activities – manufacturing, product tailoring, and sales efforts – take place outside the United States? If some, but not, all the patent-related income belongs within the U.S. taxing jurisdiction, how much? Should the answer to this question vary based on the rates of taxation imposed by Ireland, Puerto Rico, and Singapore?

Commentators have detailed the ways in which the United States does – and does not – tax cross-border income from patents and other intangible property developed partly or entirely in the United States. For the most part these commentators have illustrated, through data and through concrete examples involving primarily pharmaceutical and technology companies, that under the current rules U.S. multinational corporations ("MNCs") often are able to pay little U.S. or foreign tax on this cross-border intangible income.[3] Some commentators have offered reform proposals aimed at increasing the U.S. tax burden on this income, largely through changes to the transfer pricing rules.[4]

Through hearings and legislation, members of the U.S. Congress also have expressed views about the U.S. taxation of cross-border intangible income. Some members of Congress have argued that U.S. MNCs should pay more tax on their cross-border intangible income, but members also have been concerned about the competitiveness of U.S. MNCs in relation to foreign MNCs.[5]

This article offers a descriptive and thematic approach to understanding some of the special rules that Congress has written – and that it might write in the future – concerning the taxation of cross-border intangible income. Part II of the article describes several special Internal Revenue Code ("Code") rules addressed at the taxation of cross-border intangible income and argues that these special rules reflect Congress's attempt

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[3] *E.g.*, Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); Jesse Drucker, *Forest Laboratories' Globe-Trotting Profits*, BLOOMBERG BUSINESSWEEK, May 13, 2010, at xx, *available at* http://www.businessweek.com/magazine/content/10_21/b4179062992003.htm#r=auth-s (last visited Oct.1, 2012); Jesse Drucker, *The Tax Haven That's Saving Google Billions*, BLOOMBERG BUSINESSWEEK, Oct. 21, 2010, at xx, *available at* http://www.businessweek.com/magazine/content/10_44/b4201043146825.htm (last visited Oct. 1, 2012); Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*,NEW YORK TIMES, Apr. 29, 2012, at A1, *available at* http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?pagewanted=all (last visited Oct. 1, 2012); Simpson, *supra* note 1; Martin A. Sullivan, *Economic Analysis: Drug Company Profits Shift Out of the United States*, 126 TAX NOTES 1163 (2010).

[4] *E.g.*, Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 WORLD TAX J. 3 (2010); Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FL. TAX REV. 497 (2009); Michael A. Durst, *A Suggested Addition to the Transfer Pricing Guidelines*, 134 TAX NOTES 1315 (2012); Michael A. Durst, *A Two-Option Compromise for Intangibles Pricing Guidelines, 135 Tax Notes 1277* (2012).

[5] For examples of these competing views, *see* transcript of *Hearing Before the House Committee on Ways and Means on Transfer Pricing Issues*, 111th Cong. (2010).

over time to balance two competing policies. These two policies – on the one hand, stopping the tax-favored shifting of intangible property and income out of the United States and, on the other hand, avoiding more burdensome U.S. taxation of U.S. MNCs' cross-border intangible income than the taxation imposed by other countries on similar income derived by foreign MNCs – are versions of the two competing policies, capital export neutrality and capital import neutrality, that have dominated the five-decades-old narrative about U.S. international tax policy generally. Part III surveys five recent proposals related to the taxation of intangible income and argues that these proposals are based on the same two policies that explain the special current law rules described in Part II. Part III also identifies a third policy objective of several of the recent proposals – encouraging U.S. research – and illustrates that this policy, like the two themes identified in Part II, is not new. In Part IV I argue that although the recent proposals surveyed in Part III do not represent a fundamental rethinking of how the United States should tax U.S. MNCs' cross-border intangible income, the proposals include at least two elements – destination-based rules and formula-based rules – that represent significant departures from current international tax rules. These destination- and formula-based rules raise questions about the role of two central features of the current international tax structure, source-based taxation and arm's-length transfer pricing rules, and might suggest new directions for U.S. international tax policy.

Before the thematic overview of current rules and the glimpse into the future, the article first defines intangible income and then provides data that show why the taxation of cross-border intangible income matters.

I. The Meaning and Importance of Intangible Property

What is intangible property?

Because the meaning of intangible property may not be self-evident, discussion of the taxation of cross-border income from intangible property must start with a definition. If in concept the corporate income tax captures all returns to a corporation's equity capital, one might think of the taxation of an MNC's income from intangible property as applying to all the returns to the MNC that are not attributable to the corporation's equity capital that is invested in tangible assets.[6] For example, if a company had a single tangible asset, a factory for building cars, and it was known that the factory generated a 12-percent return on the investment in the factory, but the company's return on all equity capital was 20 percent, the eight-percent return not attributable to the investment in the factory would be income from intangible property. In this example, the intangible property might include a secret manufacturing process, patents on technology used in car components, and the company's brand name.

When the Code defines intangible property, it does so not do so by resort to this residual concept, but instead by referring to specific items of property. Two important cross-border tax rules related to intangible property income, the special rules for transfers of intangible property by domestic corporations to foreign corporations and the special transfer pricing rule for transfers or licenses of intangible property, define intangible property broadly as "any – (i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system,

[6] This description of returns from intangible property is informed by the author's discussions with Thomas A. Barthold, chief of staff of the Joint Committee on Taxation.

procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual."[7]

Pfizer's income attributable to its patents on its cholesterol-reducing drug Lipitor was intangible property income. Google's income attributable to its proprietary search software is intangible property income. Coca Cola's income attributable to its secret formula for the eponymous soda is intangible property income. Procter & Gamble's income from laundry detergent sales related to the brand name Tide is intangible property income. This recitation of examples of intangible property income may seem straightforward, but it also should prompt one question that (along with others) makes the taxation of intangible property income anything but straightforward: When a company has revenues from, for example, product sales, how might a taxpayer or the IRS decide the amount of income that is attributable to intangible property rather than to, for instance, the machines that make the company's products? Special rules for intangible income, broadly defined, may necessitate such a determination.

Why does the taxation of intangible property income matter?

[7] I.R.C. §§ 367(d) and 482, defining intangible property income by reference to section 936(h)(3)(B), the definition of intangible property in the intangible property income rules of the now-expired tax credit for economic activity in Puerto Rico and the other U.S. possessions. The last phrase of this definition ("which has substantial value independent of the services of any individual") highlights the concept of intangible income: the value of an employee's services is represented by the wages paid to that employee, and returns generated by employees that are in excess of the employees' wages are intangible property returns to the extent they are not attributable to investment in tangible capital such as an income-producing machine. Returns generated by labor in excess of wages might, for instance, be attributable to the unique way in which a company organizes the assembly line production of the goods that it sells. This unique organizational method is intangible property.

The rule for the source of income from the sale of intangible property defines intangible property in an overlapping manner as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise or other like property." I.R.C. § 865(d)(2).

Decisions about how to tax intangible income are important because under various measures intangible property contributes significantly to economic growth and to the revenues of U.S. MNCs. Reliable estimates of aggregate values of intangible property owned by U.S. MNCs or in the U.S. economy as a whole are scarce, but three broad measures – business spending on intangible property; spending on research and development; and U.S. MNCs' revenues from royalties – confirm the economic importance of intangibles.

Businesses spend large sums on intangible property, both in absolute terms and relative to the overall economy. One study has found that U.S. businesses spent in the aggregate about $1.2 trillion annually on intangible property from 1998 through 2000, approximately 13 percent of gross domestic product ("GDP") in those years.[8] The authors of the study concluded that most, but not all, about $1 trillion of this $1.2 trillion of spending on intangible property – about 10 to 11 percent of GDP –, should be considered investment in long-lasting capital that increased the economy's productive capacity.[9] This amount of business investment in intangibles was, according to the study, about the same as the amount of business investment in tangible property in the same years.[10]

Studies of research and development spending similarly confirm the centrality of intangible property. Research and development creates intangible property when, for example, it leads to discoveries that are patented. Although patents and other intangible

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[8] Carol Corrado et al., *Measuring Capital and Technology: An Expanded Framework, in* MEASURING CAPITAL IN THE NEW ECONOMY 11, 30 (Carol Corrado et al. eds, Nat'l Bureau of Econ. Research, 2005).

[9] *Id.* at 34.

[10] *Id.* at 30-35.

property that result from research and development increase the economy's productive capacity, official GDP measures by the U.S. Department of Commerce's Bureau of Economic Analysis ("BEA") treat spending on research and development as an expense rather than as investment that has long-lasting effects on the economy.[11] Recognizing that its official measures fail to capture the economic effects of research and development, the BEA has created what it calls a research and development "satellite account" that is a source of statistics for inquiry into the economic consequences of research and development.[12] Among other things, the satellite account provides estimates of the effects on GDP of treating research and development as investment rather than as an expense. In its most recent estimate, the BEA has concluded that GDP in inflation-adjusted terms would have been 2.6 percent higher annually, on average, from 2002 through 2007 had research and development been treated as investment rather than as spending.[13]

For-profit businesses, nonprofit organizations, and the government engage in research and development activities. It is research and development undertaken by for-

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[11] Consistent with international standards, the BEA plans to begin treating research and development spending as capital investment as part of a revision of the national income and product accounts in 2013. *See* BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE, CONCEPTS AND METHODS OF THE U.S. NATIONAL INCOME AND PRODUCT ACCOUNTS (CHAPTERS 1-9) ch. 2, p. 3 (2011). The current version of the System of National Accounts, which is an internationally-agreed-upon framework for the compilation and reporting of national economic statistics, recommends treating research and development as part of capital formation, a change from the treatment of research and development in the previous version, System of National Accounts 1993. *See* SYSTEM OF NATIONAL ACCOUNTS 2008, EUROPEAN COMMUNITIES, INTERNATIONAL MONETARY FUND, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, UNITED NATIONS & WORLD BANK 583, 585 (2009). For a comparison of the BEA's national income and product accounts with the System of National Accounts, *see* Charles Ian Mead et. al, *The NIPAs and the System of National Accounts,* SURVEY OF CURRENT BUSINESS, Dec. 2004, at 17.

[12] For the BEA's research related to this satellite account and innovation more broadly, *see* http://www.bea.gov/national/newinnovation.htm (last modified May 23, 2011).

[13] Jennifer Lee & Andrew G. Schmidt, *Research and Development Satellite Account Update: Estimates for 1959-2007,* SURVEY OF CURRENT BUSINESS, Dec. 2010, at 16, 17.

profit businesses that is the most relevant to an article on the taxation of cross-border intangible property income. Under the convention that treats research and development as investment rather than as an expense, business (as opposed to nonprofit or government) research and development contributed 0.20 percentage points to the 2.2 percentage point increase in inflation-adjusted GDP from 2006 to 2007; government and nonprofit research in combination contributed 0.08 percentage points to this GDP growth.[14] As one more illustration of the economic effects of research and development, if research and development spending had been treated as investment, private fixed investment in 2007 would have been, in inflation-adjusted terms, $256.4 billion, or 11.3 percent, higher than the official measure of private fixed investment in that year.[15]

Research and development is important not only in the economy as a whole. It is also a significant component of the value added by U.S. MNCs.[16] If a U.S. MNC's research and development expenditures are treated as investment, these expenditures no longer reduce the MNC's profits, and the firm's value added, of which one component is profits, increases correspondingly. In 2008, the value added of parent companies of U.S. MNCs would have increased by $182.5 billion, or 7.2 percent, if research and development had been treated as investment.[17] The 2008 figures for majority-owned foreign affiliates of U.S. MNCs are $35.4 billion and 2.8 percent.[18]

[14] *Id.* at 17-18.

[15] *Id.* at 18.

[16] An MNC's value added is the portion of its output attributable to its own production. In dollar terms this value added is the sum of costs incurred in (excluding intermediate inputs), and profits from, production. *Id.* at 26.

[17] *Id.*

[18] *Id.*

Intangible property is important to U.S. MNCs under a third measure, the volume of royalties and license fees paid between U.S. MNCs' parent corporations and their foreign affiliates. Royalties and license fees are amounts paid for the use of intangible property such as patents, trademarks, and copyrights. In 2010 U.S. parent corporations received $63.1 billion (not adjusted for inflation) in royalties and license fees from their foreign affiliates and paid $5.3 billion of royalties and license fees to these affiliates, for total net receipts of $57.8 billion.[19] By comparison, in the same year U.S. parent corporations had an aggregate total return of $409.5 billion attributable to their equity ownership of, and loans to, their foreign affiliates.[20] Accordingly, for every $7 that U.S. parent corporations earned in relation to their debt and equity investments in foreign affiliates, they received $1 in net receipts from those affiliates in royalties and license fees.[21]

II. Special Intangibles Rules with Competing Policy Goals

Special rules

Given the importance of intangible property to U.S. MNCs and in the economy as a whole, the rules for the taxation of cross-border intangible income might at first seem sparse. In part, this seeming sparseness of intangibles-specific rules in the Internal

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[19] Jeffrey H. Lowe, *Direct Investment for 2007-2010, Detailed Historical-Cost Positions and Related Financial and Income Flows,* SURVEY OF CURRENT BUSINESS, Sept. 2011, at 50, 58. In the same year U.S. affiliates of foreign MNCs paid $18.0 billion in royalties and license fees to their foreign parent corporations and received $3.3 billion in royalties and license fees, for total net receipts of $14.7 billion. *Id.* at 93.

[20] *Id.* at 58. The data refer to this aggregate total return as "direct investment income," composed of (1) the parents' shares of the net income from their foreign affiliates' operations, and (2) net interest income received by parents from loans to and trade accounts with the foreign affiliates. *Id.* at 56.

[21] Royalties and license fees were less significant relative to total returns for foreign MNCs and their U.S. affiliates. Foreign MNCs earned $143.4 billion from their equity and debt investments in their U.S. affiliates. Accordingly, for every $10 of income foreign MNCs earned on their equity and debt investments in their U.S. affiliates, they earned $1 of net receipts of royalties and license fees. *Id.* at 93.

Revenue Code masks the great complexity of those rules as interpreted by the IRS and Treasury Department. The sparseness, though, also reflects that, in contrast with some other countries, the United States does not have a schedular income tax system under which different categories of income are subject to separate income tax rules.[22] Instead, as will no doubt be familiar, "gross income," which is the base of the income tax, "means all income from whatever source derived."[23] Consequently, the Internal Revenue Code does not include a discrete set of rules for the taxation of intangible income.

Instead, as it occasionally has done for other categories of income, Congress has at different times addressed various policy aims by adding to provisions of more general application rules related specifically to the taxation of cross-border intangible income.[24] These intangibles-related tax rules in the Code, and the transfer pricing rules applicable to related-party transfers of intangible property (provided by Treasury regulations), have been described at great length elsewhere.[25] Consequently, rather than provide pages of detail about the various special rules for taxing cross-border intangible income, this article gives a brief, thematic description of certain prominent special Code rules and

[22] For a brief history and description of the United Kingdom's schedular system, *see* John Tiley, *United Kingdom, in* COMPARATIVE INCOME TAXATION 145, 153-54 (Hugh J. Ault & Brian J. Arnold eds, Kluwer Law International, 2010).

[23] I.R.C. § 61(a).

[24] Outside the context of cross-border intangible income, prominent examples of particular kinds of income to which special rules apply include domestic manufacturing income (taxed at a reduced rate under section 199); capital gains of individuals (taxed at a maximum rate of 15 percent under section 1(h)(1)); and qualified dividend income of individuals (taxed under section 1(h)(11) by reference to the tax rates in effect for individuals' capital gains).

[25] *E.g.,* JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, at 18-36 (2010); Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation ¶ A3.07 (2012); Samuel M. Maruca, *Transfer Pricing: The Code, the Regulations, and Selected Case Law,* Foreign Income Portfolios (BNA Tax Management Inc.) 886-2nd (2012).

argues that these rules reflect Congress's attempt over time to achieve competing policy goals.

The special tax rules related to cross-border intangible income can be described in terms of two themes: jurisdictional rules that have the effect of ceding to other countries the primary right to tax much foreign intangible income of U.S. MNCs, and substance-over-form rules that circumscribe the principle of respect for the separateness of related legal entities when a U.S. person transfers intangible property to a foreign affiliate.

Jurisdictional rules

The jurisdictional rules that cede to other countries the primary right to tax much foreign intangible income of U.S. MNCs comprise rules for determining the source, U.S. or foreign, of certain income and rules for whether the United States taxes currently certain income under subpart F. The source and subpart F rules most directly related to intangibles income are the rules for royalties.[26] Royalties, after all, are payments received for, among other things, a license to use intangible property, and, as was noted previously, U.S. MNCs receive tens of billions of dollars annually in royalty payments.

A royalty received for the use of intangible property such as a patent, copyright, or trademark is foreign-source income if the property is used outside the United States.[27] Under this rule, if a U.S. parent company licenses intangible property to, for example, a

[26] This article does not describe the subpart F rules for foreign base company sales income (section 954(d)) and foreign base company services income (section 954(e)). In broad terms, those rules apply to a CFC's income from cross-border sales and services in transactions involving related parties. Foreign base company sales and services income can be attributable to intangible property when income from services or the sale of tangible property includes a return related intangible property used in producing the good or service. This sort of income is often referred to as "embedded intangible income." For example, a pharmaceutical company's income from the sale of a patented medicine includes embedded intangible income to the extent the sales income relates to the patents. For a description of the foreign base company sales and services income rules, *see* JOINT COMMITTEE ON TAXATION, *supra* note 25, at 36-46.

[27] I.R.C. § 862(a)(4). Conversely, the royalty income is U.S. source if the property for which the royalty is paid is used in the United States. I.R.C. § 861(a)(4).

foreign affiliate or an unrelated foreign company, and the affiliate or unrelated company uses the property in its business outside the United States, the U.S. parent company's royalty income from the license is foreign source. Similarly, if, rather than licensing intangible property, a U.S. parent company sells intangible property in exchange for payments that are contingent on, for instance, sales attributable to the intangible property, the payments for the sale of the intangible property are treated as royalty payments and, therefore, are foreign-source if the property is used outside the United States.[28]

Foreign-source treatment of a U.S. parent company's royalties matters not because it means that the United States excludes the royalties from taxation – it does not –, but rather because foreign-source treatment helps the corporation in its foreign tax credit planning. In particular, the amount of a company's foreign tax credit is limited, in general terms, to the amount of U.S. tax imposed (before the credit) on the company's foreign-source income.[29] Foreign-source royalties received by U.S. companies are often subject to little or no foreign tax, but because they are foreign source, they increase the amount of a company's allowable foreign tax credit.[30] Consequently, companies may – and do – use foreign tax credits generated by other, highly taxed foreign income (so-called "excess credits") to offset residual U.S. tax on lightly taxed foreign royalties.[31]

[28] I.R.C. § 865(d)(2). This rule is an exception from the general source rule for income from the sale of personal property. That general rule provides that this sales income is U.S. source when derived by a U.S. resident and foreign source when derived by a nonresident. I.R.C. § 865(a).

[29] *See* I.R.C. § 904.

[30] Foreign-source royalties received by U.S. MNCs are often subject to little or no foreign tax because bilateral income tax treaties eliminate or significantly reduce withholding tax on royalty payments and because those payments are typically deductible in the country from which the payments are made.

[31] The foreign tax credit limitation rules of section 904 facilitate this cross-crediting because they treat many royalty payments – both a U.S. parent company's royalties that would qualify for the active royalties exception from subpart F (described below) if received by a CFC and royalties received by a U.S. parent company from a CFC out of the CFC's non-subpart F income – as general category rather than passive

Prominent economists have estimated that in 2000 approximately two-thirds of royalties received by U.S. MNCs were sheltered from U.S. tax by these excess credits.[32] In practice, therefore, the U.S. parent company of a U.S. MNC that owns valuable intellectual property in the form of, for example, patents or secret formulas or processes can derive intangible income from licensing this property to foreign affiliates or unrelated third parties and pay less than full U.S. tax on the income.[33]

Special subpart F rules exempt from current U.S. taxation some royalty payments that otherwise would face current U.S. taxation under the general rules of subpart F. When a U.S. person owns 10 percent or more of the stock of a foreign corporation, and five or fewer U.S. people own in the aggregate more than 50 percent of the stock of that corporation (a "controlled foreign corporation" or "CFC"), subpart F taxes each 10-percent U.S. shareholder of the CFC on a current basis on its shares of certain items of the CFC's income (the CFC's subpart F income) even if the CFC does not distribute

category income for purposes of the requirement that the foreign tax credit limitation be applied separately to separate categories of income. *See* I.R.C. §§ 904(d)(2)(B), (d)(3)(C). A consequence of treating royalties as general category income is that excess foreign tax credits from high-tax, general category income from operating a foreign business can be used to offset residual U.S. tax on the royalties.

[32] Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy, in* FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 319, 327 (John W. Diamond & George R. Zodrow eds., MIT Press, 2008).

[33] The source (or allocation and apportionment) rules for research and experimental expenses, found in Treasury regulations, not the Code, also can help a company make full use of its foreign tax credits. All else equal, a U.S. company prefers to apportion expenses to its U.S.-source gross income rather than its foreign-source gross income because an apportionment to foreign-source gross income would reduce foreign-source taxable income and thereby decrease the company's foreign tax credit limitation. The basic apportionment rule for research and experimental expenditures permits a taxpayer to apportion half of its deduction for those expenditures to U.S.-source income if it performs research and experimentation activities that account for more than half of the amount of the deduction in the United States. Treas. Reg. § 1.861-17(b)(1)(i). The other half of the deduction is apportioned based on the location of sales of products related to the research and experimentation. Treas. Reg. § 1.861-17(c)(1). (Taxpayers may elect an optional gross income method.) Consequently, a company that carries out most of its research in the United States may treat half of its research expenditures as reducing U.S.-source, rather than foreign-source, gross income even if it could be shown that as a factual matter some of the U.S.-apportioned expenses generated foreign-source income by, for example, leading to the creation of patented products that were mostly sold abroad.

earnings to its shareholders.[34] Subpart F generally is intended to prevent U.S. persons engaged in foreign business operations from avoiding U.S. tax on passive investment income or on certain sales or services income that can easily be shifted from one country (such as the United States) to another country (such as a low-tax foreign jurisdiction).[35] One category of subpart F income, foreign personal holding company income, includes passive investment income such as dividends, interest, rents, and royalties.[36] Consequently, in the absence of special rules to the contrary, if a CFC wholly owned by a U.S. corporation licensed intangible property to an affiliate or unrelated party and in exchange received royalties, the United States would tax the U.S. parent corporation on the royalties at the time they were received. The United States would thereby collect tax on intangible income of CFCs to the extent that income consisted of royalties.

Two exceptions, however, relieve this taxation. The so-called active royalties exception exempts from foreign personal holding company income royalties that are received in the active conduct of a trade or business from unrelated persons.[37] And the so-called CFC look-through rule, a temporary provision that expired at the end of 2011 (but which, if history is a guide, may be extended retroactively), excluded from foreign personal holding company income dividends, interest, rents, and royalties received by

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[34] The subpart F rules are in Code sections 951 through 964.

[35] *See* H.R. REP. NO. 87-1447, at 58 (1962) ("[T]he testimony before your committee did convince it that many [U.S. MNCs] have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income. . . . Your committee has also concluded that U.S. tax should be imposed currently, on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business . . .").

[36] I.R.C. § 954(c)(1)(A).

[37] I.R.C. § 954(c)(2)(A). The exception also applies to rents. A narrower exception applies to rents and royalties received from related parties. Under this exception, a royalty (or rental) payment is not foreign personal holding company income if it is received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. I.R.C. § 954(c)(3)(A)(ii).

one CFC from another CFC to the extent that, among other requirements, the payments were not attributable to subpart F income of the paying CFC.[38] As a result of these exceptions from subpart F, to the extent the intangible income of U.S. MNCs consists of royalties derived by CFCs from licensing intangible property as part of their business operations, the U.S. MNCs avoid current U.S. taxation of this intangible income without resort to sophisticated planning.[39]

Substance-over-form rules

Two rules that apply to transfers of intangible property by a U.S. person to a foreign affiliate elevate the substance of the transfer over its form and thereby circumscribe the more general respect for the separateness of related legal entities. The two rules are the commensurate-with-income requirement for related-party transfers of

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[38] I.R.C. § 954(c)(6).

[39] This observation is not intended to suggest that U.S. MNCs do not have the need for sophisticated tax planning in relation to intangible property or more generally. That planning, however, often is in relation to other issues. For example, much U.S. MNC cross-border tax planning is intended to minimize foreign taxes without causing a corresponding increase in U.S. taxation – as one possibility, by reason of the foreign base company rules of subpart F.

U.S. MNCs commonly enter into contract manufacturing arrangements that avoid generating foreign base company sales income only if the arrangements satisfy the detailed contract manufacturing rules promulgated in 2009. *See* T.D. 9438, 2009-1 C.B. 387 (2009). These contract manufacturing arrangements may achieve tax savings by, for instance, assigning high returns from ownership of tangible and intangible property, manufacturing oversight, assumption of various business and legal risks, and other activities to an entity referred to as a "principal" that is organized in a low-tax jurisdiction such as Switzerland and by assigning low returns from physical manufacturing to contract manufacturers in one or more higher-tax jurisdictions such as Germany. These arrangements may achieve non-tax objectives such as the efficient allocation of an MNC's global resources. For a description of the contract manufacturing regulations and the use of contract manufacturing for tax and non-tax reasons, see JOINT COMMITTEE ON TAXATION, *supra* note 25, at 15, 37-45.

U.S. MNCs also must take care that their foreign tax planning does not create subpart F income by reason of the foreign base company services income rules. Foreign base company services income arises from services performed by a CFC outside its country of organization for or on behalf of a related person. Services performed on behalf of a related person include situations in which a related person has provided "substantial assistance" to the CFC's performance of services. Treas. Reg. § 1.954-4(b)(1)(iv). U.S. MNCs commonly enter into transactions in which CFCs receive substantial assistance. Under guidance issued in 2007, assistance is considered substantial assistance only if it is provided by a related U.S., not foreign, person and only if the costs of the assistance are at least 80 percent of the total costs of the CFC in performing the services. IRS Notice 2007-13; 2007-1 C.B. 410 (2007).

intangible property under the transfer pricing rules of Code section 482 and the similar section 367(d) commensurate-with-income requirement for transfers of intangible property by domestic corporations to foreign corporations. The principle of respect for legal form is central to the more general rules in which the special commensurate-with-income rules are found. Section 482 gives the Treasury Secretary nearly unparalleled authority to allocate income between related taxpayers. The only direction to the Secretary is that the income allocation must be necessary to prevent tax evasion or to clearly reflect the income of any one of the taxpayers. Given such a broad grant of regulatory authority, one could imagine a scenario in which the IRS and Treasury Department had written regulations that treated a commonly controlled group of taxpayers as a single entity and apportioned the group's income across jurisdictions based on objective – or, depending on one's perspective, arbitrary – criteria such as the location of sales, tangible capital, or labor.[40] In reality, however, the IRS and Treasury have interpreted their authority by promulgating regulations that implement the arm's-length standard – the standard "of a taxpayer dealing at arm's length with an uncontrolled entity."[41] This arm's-length standard presupposes that related parties are separate from one another and that the government should adjust transactions between parties only to

[40] This method of allocating income to members of a commonly-controlled multinational group of corporations is known as formulary apportionment. For an argument that the United States should adopt a formulary apportionment system for taxing the income of MNCs, see Avi-Yonah et al., *supra* note 4.

[41] The transfer pricing regulations have undergone great transformation over the last four decades. The first set of Treasury regulations providing methods for implementing the arm's-length standard took effect in 1968. For a history of transfer pricing regulations and judicial decisions since then, and an argument that more recently promulgated transfer pricing methods such as the profit split method have departed from the traditional conception of the arm's-length standard, see Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation,* 15 Va. Tax Rev. 89 (1995).

align the transactions with the same or similar transactions between wholly independent parties.

Section 367 similarly presupposes as a general matter that when a domestic corporation transfers property to a foreign corporation, the two entities are separate from one another – even if, among other possibilities, the domestic corporation controls the foreign corporation after the transfer. Section 367 applies in situations in which the tax rules otherwise would permit the transferor corporation to recognize no gain (and would bar recognition of any loss) on its transfer to the foreign corporation because, among other possibilities, the transaction satisfied the requirements of a stock-for-stock reorganization that qualifies for nonrecognition treatment under section 354. Nothing about the tax-free reorganization rules disregards the separateness of the transferor and transferee corporations. The rules merely alter whether an exchange between the parties is taxable immediately. Similarly, nothing about section 367, which turns off the normal rule of non-taxability in various cross-border transactions, dictates that a transfer from one corporation to another is not a transfer between two separate entities. To the contrary, section 367 reinstates all the normal tax consequences in such a transfer, thereby confirming the separateness of the two entities.

Congress enacted the commensurate-with-income rules of sections 482 and 367(d) based on the conflicting principle of substance over form. Both rules require that, when one taxpayer transfers or licenses intangible property to another taxpayer, the income in respect of that transfer must be commensurate with the income attributable to the intangible. The section 482 commensurate-with-income requirement applies to actual sales or licenses of intangible property from one related taxpayer to another. The section

367(d) commensurate-with-income requirement applies when a domestic corporation transfers intangible property to a foreign corporation not in a sale or a license, but instead (as one common example) in an exchange in which the domestic transferor corporation receives stock of the foreign transferee corporation and controls that foreign corporation immediately after the exchange. When they apply, the commensurate-with-income rules permit the government to adjust the income stream of the domestic transferor corporation to reflect the income stream of the transferred intangible. This adjustment may take the form of imputed royalty payments. Imputed royalty payments respect the transaction as formally occurring between two separate taxpayers, thus conforming to the principle of respect for legal separateness. In substance, however, the result is comparable to the transferor's not having made the transfer and instead having received income from the intangible property directly. This result elevates substance – here, the proposition that the transferor of the intangible should include in income an appropriate return on the intangible – over the form of the transaction, which is that the price of the transfer was negotiated by separate legal entities and should be respected.

Competing policy goals

Congress has enacted a variety of special rules for cross-border intangible income because it has tried over time to balance competing policy goals. With some rules, Congress has sought to stop tax-favored migration of U.S. MNCs' intangible property and income to low-tax foreign jurisdictions. In other rules, Congress has tried to avoid imposing on U.S. MNCs' cross-border intangible income more burdensome taxation than the taxation that other countries impose on similar income derived by U.S. MNCs' foreign competitors.

Congress has attempted to stop the tax-favored migration of intangible property and income to low-tax foreign jurisdictions by taxing 10-percent U.S. shareholders on their shares of CFC royalty income and by enacting the commensurate-with-income rules of sections 367(d) and 482. According to the legislative history accompanying the House of Representatives' version of the Revenue Act of 1962, the Ways and Means Committee chose to include in its subpart F rules a provision – broader than the rule that made it into the enacted law, but the same in its imposition of current U.S. tax on CFC royalty income – that taxed 10-percent U.S. shareholders currently on their undistributed shares of CFC income from, among other things, the license or sale of patents and copyrights substantially developed in the United States "on the grounds that where a patent, copyright, etc., was developed or created in the United States, it is likely that, if it were not for lower taxes abroad, the rights to it would still be held by the domestic company with this company merely licensing its use by the foreign corporation."[42] In other words, in the absence of a rule imposing current taxation of intangible income derived by CFCs, U.S. MNCs would have an incentive to transfer patents and other intangible property to CFCs that could derive lightly taxed foreign income from the property.

The legislative history to the Tax Reform Act of 1986 includes a similar rationale for the commensurate-with-income rules of sections 367(d) and 482. The Ways and Means Committee report accompanying the House version of the 1986 law, which included the commensurate-with-income rules in almost the identical form in which they were ultimately enacted into law, described the reason for those rules as follows:

[42] H.R. REP. NO. 87-1447, at 61 (1962). The provision was in section 13(a) of the bill, H.R. 10650, 87th Cong. (1962). It was a broad provision because it taxed a 10-percent U.S. shareholder of a CFC on its share of not only royalty payments received by the CFC, but also income of the CFC from the sale of goods when the CFC used a U.S.-developed patent, copyright, or exclusive formula or process in manufacturing the goods – that is, embedded intangible income.

> There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.[43]

The committee expressed concern that the transfer pricing and outbound transfer rules of sections 482 and 367 were not preserving U.S. taxation of an adequate amount of income when a U.S. person transferred intangible property to a related foreign person. It concluded that, by contrast with the outcomes when related-party transfers of intangibles were judged by reference to unrelated-party transfers, a rule taxing the U.S. transferor on an amount commensurate with the income attributable to the transferred intangible property would guarantee an appropriate level of U.S. taxation in relation to that property.[44]

The 1962 law change related to CFC royalty income and the 1986 enactment of the commensurate-with-income rules thus exhibit congressional concern that the then-current rules gave taxpayers an incentive to transfer intangible property and, with it, the income from that property to affiliates in low-tax countries. Congress has sought to balance that concern with the conflicting objective of not disadvantaging U.S. MNCs in relation to their foreign peer firms by taxing the U.S. MNCs' foreign intangible income in a more burdensome manner than the taxation imposed on similar income derived by

[43] H.R. REP. NO. 99-426, at 423 (1985).

[44] *Id.* at 423, 425.

foreign firms. This latter objective explains the active royalties exception and the more recent CFC look-through rule. As described previously, the House version of the Revenue Act of 1962 included a broader provision than was ultimately enacted into law for taxing a U.S. shareholder currently on a CFC's income from patents, copyrights, and other intangible property. The Senate version of the bill that became law provided the active royalties exception of current law, the rule under which royalties (and rents) are not foreign personal holding company income if they are received in the active conduct of a business from unrelated parties. A single sentence in the Senate Finance Committee report accompanying the Senate bill describes the reason for this exception while also justifying the general imposition of current taxation of undistributed passive investment income of CFCs: "Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments. . . ."[45] In the context of the enactment of subpart F, keeping a U.S. MNC's foreign business operations on "an equal competitive footing" with non-U.S. firms' operations in the same countries meant, among other things, not taxing what would normally be considered portfolio income if that income was derived from unrelated third parties as part of the U.S. MNC's business.

The Ways and Means Committee had the same rationale for including the temporary CFC look-through rule in 2005 tax legislation. The CFC look-through rule can be seen as an expansion of the active royalties (and rents) exception because it

[45] S. REP. NO. 87-1881, at 83 (1962).

applies to dividends and interest as well as to royalties and rents and because it is available for payments from related CFCs as opposed to from unrelated taxpayers. The committee report describes the reason for the look-through rule in competitiveness terms: "Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries."[46] In other words, the U.S. rules burdened U.S. MNCs more heavily than the tax laws of foreign countries burdened foreign MNCs when an entity in the MNC group used business earnings to make a cross-border royalty or other payment to another entity in the group. The Ways and Means Committee wanted to end what it viewed as a competitive disadvantage.

Readers familiar with debates over international tax policy will have noticed that the competing policy goals underlying the various rules for cross-border intangible income are the same as the competing theoretical justifications for the broader scheme of international taxation. Participants in the debate about the proper theoretical basis for the U.S. international tax regime have argued over different neutralities.[47] Congress's attempt to prevent the tax-favored migration of intangible property and income can be understood as part of a larger view that the U.S. tax rules should not create a preference

[46] H. REP. NO. 109-304, at 45 (2005).

[47] For a review and criticism of the original neutrality concepts, and a description of a more recent ownership neutrality framework, see James R. Hines Jr., *Reconsidering the Taxation of Foreign Income,* 62 TAX L. REV. 269 (2009). *See also,* Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting,* 57 NAT'L TAX J. 937 (2004) (among other things, describing the capital ownership neutrality benchmark). For an argument that debates based on these neutrality theories fail to distinguish between two margins on which U.S. international tax rules affect U.S. taxpayers' investment decisions – the overall tax burden on foreign investment and the rate at which the U.S. tax system reimburses foreign taxes – *see* Daniel N. Shaviro, *Rethinking Foreign Tax Creditability,* 63 NAT'L TAX J. 709 (2010).

for foreign investment over domestic investment. In the international tax jargon this view has been termed capital export neutrality. Congress's objective of not subjecting U.S. MNCs to more burdensome taxation of their cross-border intangible income than the taxation faced by foreign MNCs operating in the same jurisdictions can be understood as part of a broader view that the U.S. tax rules should aim for equal taxation of a U.S. firm and a foreign firm that are operating in the same (third) country. The international tax lingo has given this perspective the name capital import neutrality. Arguments over the taxation of cross-border intangible income have persisted alongside the more general debate about the U.S. scheme for taxing cross-border income for many decades. The discussion has been particularly active in the last several years, and policy makers have proposed changing the ways in which the United States taxes cross-border intangible income, a topic to which this article now turns.

III. New Proposals, Old Goals

As described near the beginning of this article, stories in the popular press and articles in tax practice publications and academic journals have revealed discontent with the U.S. taxation of cross-border intangible income.[48] The discontent has centered on the argument that the current rules inappropriately permit U.S. MNCs to escape U.S. taxation of income attributable to intangible property developed in or otherwise connected to the United States. At the same time, some policy makers and U.S. MNCs have argued that the U.S. international tax rules as a whole disadvantage U.S. MNCs relative to their foreign competitors.[49] Policy makers have released comprehensive international tax

[48] *See* note 3, *supra*.

[49] For example, in introducing a hearing at which chief financial officers of four U.S. multinational corporations testified, House Ways and Means Committee Chairman Dave Camp stated, "[T]he U.S. is one

reform proposals and proposals that more specifically address cross-border intangible income (in two cases, within comprehensive reform proposals). This part III situates five recent, specifically intangibles-directed proposals in the context of the competing policy goals of stopping tax-favored intangible property migration and of avoiding U.S. taxation of U.S. MNCs' cross-border intangible income that is more burdensome than foreign taxation of foreign MNCs' intangible income. It also introduces a third policy goal – encouraging U.S. research activities – that partly or entirely explains several of the recent proposals and that also is the basis of the (currently expired) research and experimentation tax credit.

The discussion includes five proposals: (1) President Obama's budget proposal to tax so-called "excess returns" associated with transfers of intangible property from the United States to low-tax foreign countries (the "excess returns proposal");[50] (2) Ways and Means Chairman Dave Camp's proposal, included as part of his discussion draft of a bill to adopt a dividend exemption system for taxing foreign business income of CFCs, to subject CFCs' intangible income to current U.S. taxation and to tax U.S. parent companies' and CFCs' foreign intangible income – that is, intangible income related to sales and services to foreign customers – at a reduced rate (commonly, and in this article,

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of the last major economies to operate a worldwide system for active business income, which many believe is a further barrier to the growth of American companies. Capital will find its way to the most profitable opportunities around the world. But when U.S. companies must pay an additional U.S. tax on top of the tax they pay in the foreign market, then that capital is more likely to be invested through foreign companies who do not face this additional tax." *Hearing Before the House Committee on Ways and Means on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers,* 112th Cong. (2011).

[50] DEPARTMENT OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 88 (2012) [hereinafter *Excess Returns*]. Similar proposals were included in the fiscal year 2011 and 2012 budgets.

referred to as "Option C");[51] (3) Senator Michael Enzi's proposal, likewise included in a larger international tax reform bill, to subject CFCs' low-tax foreign income, including intangible income, to current U.S. taxation and to tax U.S. parent companies at a reduced rate on their foreign intangible income attributable to U.S. business operations (the "Enzi proposal");[52] (4) Senator Dianne Feinstein's proposal, not in the form of introduced legislation, to institute a so-called "patent box" regime under which the United States would tax income from the sale of patented products that are manufactured in the United States at a preferential 15-percent rate (the "Feinstein patent box");[53] and (5) a proposal by Representative Allyson Schwartz to tax certain patent-related income at a 10-percent rate (the "Schwartz patent box").[54]

Anti-migration

One of the two policy goals described previously, stopping the tax-favored migration of intangible property and income overseas, explains the excess returns proposal and elements of Chairman Camp's Option C and the Enzi proposal. The excess returns proposal taxes currently under subpart F all or a portion of the income from transactions connected with or benefitting from intangible property transferred by a U.S. person to a related CFC if the income is subject to an effective foreign tax rate of less than 15 percent and to the extent the income exceeds costs related to the income plus a

[51] HOUSE COMMITTEE ON WAYS AND MEANS, DISCUSSION DRAFT (2011), *at* http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf (last visited Sept. 30, 2012) [hereinafter *Discussion Draft*].

[52] United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. §§ 103, 201 (2012).

[53] Leveling the Playing Field Act of 2012, *at* http://www.feinstein.senate.gov/public/?a=Files.Serve&File_id=c7efe846-c626-40a5-b9b3-1a8b2c5e589a (last visited Sept. 30, 2012).

[54] Manufacturing American Innovation Act of 2012, H.R. 6353, 112th Cong. (2012).

percentage markup.[55] Intangible property transfers that trigger application of the proposal include sales, leases, licenses, and shared risk or development agreements (including cost sharing arrangements).[56] The "Reasons for Change" section of the proposal includes the following statement about the rationale for the proposal:

> There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions.[57]

Elements of Chairman Camp's Option C and the Enzi proposal are similarly aimed at reducing U.S. MNCs' U.S. tax incentive to transfer intangible property to low-taxed foreign affiliates. Option C does a couple things, one of which is taxpayer favorable and is described later. The anti-intangible-shifting element of Option C provides current U.S. taxation under subpart F of a CFC's intangible income if the income is subject to an effective foreign tax rate of not more than 60 percent of the maximum U.S. corporate tax rate.[58] To the extent the intangible income is foreign intangible income, meaning that it is

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[55] *Excess Returns*, *supra* note 50, at 88-89. If the effective foreign tax rate imposed on the income is 10 percent or less, all the income is taxed currently in the United States. The proposal phases out current U.S. taxation ratably at rates from 10 to 15 percent. The proposal itself does not state the percentage markup to be used in determining the amount of a taxpayer's income that is subject to the proposal, but legislative language that the Administration released in fall 2011 as part of a broad economic plan provides that income attributable to the use or exploitation of intangible property is excess income only to the extent the income exceeds 150 percent of the costs attributable to the income. *See* THE PRESIDENT'S PLAN FOR ECONOMIC GROWTH AND DEFICIT REDUCTION: LEGISLATIVE LANGUAGE AND ANALYSIS, *reprinted in* TAX NOTES TODAY, Sept. 28, 2011 (Tax Analysts Doc. No. 2011-20562).

[56] *Excess Returns, supra* note 50, at 89.

[57] *Id.* at 88.

[58] *Discussion Draft*, *supra* note 51, § 331C. The draft creates a new category of foreign base company for this income, "foreign base company intangible income." This income is a CFC's income from either the sale, lease, license, or other disposition of property in which intangible property is used directly or

derived in connection with servicing a foreign market, current U.S. taxation under subpart F is at a reduced, 15-percent rate.[59] Intangible income derived in connection with serving the U.S. market is taxed at the Discussion Draft's regular 25-percent corporate tax rate. The anti-shifting element of the Enzi proposal is a new category of subpart F income, "low-taxed income," for income of a CFC that is subject to an effective foreign tax rate of not more than half the U.S. corporate tax rate (which remains unchanged at 35 percent under Sen. Enzi's bill).[60] The Enzi proposal excludes from this new subpart F category income that satisfies certain requirements for being considered "qualified business income."[61] In no event, however, is intangible income qualified business income.[62] Accordingly, the Enzi proposal treats a CFC's intangible income that is subject to a foreign tax rate of 17.5 percent or less as low-taxed income subject to current U.S. taxation in all circumstances.

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indirectly or the provision of services related to intangible property or in connection with property in which intangible property is used directly or indirectly – but in either case, only to the extent that the income is properly attributable to the intangible property. Intangible property is defined by reference to the broad definition under section 936(h)(3)(B) (described previously). Accordingly, foreign base company intangible income includes not only, as one example, royalties, but also the portion of income from sales or services that is attributable to intangible property (as noted previously, commonly referred to as "embedded intangible income"). For instance, embedded intangible income includes the portion of income from the sale of a prescription drug that is attributable to the drug's patents.

[59] *Id.* More specifically, the Discussion Draft defines foreign intangible income as intangible income derived in connection with (1) property that is sold for use, consumption, or disposition outside the United States or (2) services provided with respect to persons or property located outside the United States. Thus, for example, the intangible income attributable to prescription drug sales to foreign consumers is foreign intangible income. The amount of the rate reduction in the Discussion Draft is in brackets, meaning that the amount is left open for discussion. The bracketed amount is a 40-percent deduction from income taxed at the generally prevailing 25-percent corporate tax rate that the Discussion Draft provides (in section 201), with the result that foreign intangible income derived by a CFC would be taxed at 15 percent.

[60] United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 201 (2012).

[61] *Id.*

[62] *Id.* Intangible income has the same meaning as it does in the Camp Draft. *Id.* § 103.

Senator Enzi's statements related to his bill make no specific mention of the bill's special rule for intangible income, but Chairman Camp's statements related to his Option C might also explain the Enzi proposal. A one-page summary of the Discussion Draft states that the draft "[i]ncludes a number of anti-abuse rules to prevent erosion of the U.S. tax base and help make the participation exemption system a revenue neutral component of tax reform, such as: . . . [i]ncome shifting rules that prevent U.S. companies from avoiding U.S. tax by transferring highly valuable intangible property to foreign companies that pay little or no tax."[63] This statement expresses a policy concern strikingly similar to the concern expressed in the legislative history of the 1986 commensurate-with-income rules that taxpayers had "a strong incentive . . . to transfer intangibles to related foreign corporations . . . in a low tax jurisdiction."[64] That statement, in turn, differs little from the view expressed in the 1962 subpart F legislative history that when a patent is developed in the United States it would likely remain in the United States, with rights to its use abroad granted to foreign related parties by license "if it were not for lower taxes abroad."[65] The concern about income shifting through migration of intangible property abroad has remained remarkably consistent over fifty years.

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[63] HOUSE COMMITTEE ON WAYS AND MEANS, HIGHLIGHTS OF WAYS AND MEANS DISCUSSION DRAFT: PARTICIPATION EXEMPTION (TERRITORIAL) SYSTEM, *at* http://waysandmeans.house.gov/uploadedfiles/territorial_one_pager.pdf (last visited Sept. 30, 2012). The Discussion Draft provides two alternative "anti-abuse" rules, the excess returns proposal (referred to in the draft as Option A) and, like the Enzi bill, a low-tax test for current U.S. taxation under subpart F (Option B). According to a three-page summary of the bill, Options A, B, and C "[a]ddress concerns expressed by commentators that under a participation exemption system, U.S. companies would have an increased incentive to shift income to foreign jurisdictions, especially through the migration of intangible property overseas." HOUSE COMMITTEE ON WAYS AND MEANS, SUMMARY OF WAYS AND MEANS DISCUSSION DRAFT: PARTICIPATION EXEMPTION (TERRITORIAL) SYSTEM, at 2 , *at* http://waysandmeans.house.gov/uploadedfiles/summary_of_ways_and_means_draft_option.pdf (last visited Sept. 30, 2012) [hereinafter *Discussion Draft Summary*].

[64] H.R. REP. NO. 99-426, at 423 (1985).

[65] H.R. REP. NO. 87-1447, at 61 (1962).

Avoiding relative burdens

The second of the two previously mentioned policy goals, the concern to avoid taxation of U.S. MNCs' intangible income at a level that would unduly burden U.S. MNCs relative to their foreign competitors, partly explains other elements of Option C and the Enzi proposal. As described previously, Option C taxes CFCs' foreign intangible income – that is, intangible income derived in connection with (1) property that is sold for use, consumption, or disposition outside the United States or (2) services provided with respect to persons or property located outside the United States – at a significantly reduced (15 percent) rate. Option C also provides that if a U.S. parent company derives foreign intangible income directly, rather than through a CFC, the U.S. parent company is taxed on the income at the same reduced rate.[66] The Enzi proposal includes a similar feature: It taxes a U.S. parent corporation's "qualified foreign intangible income" – foreign intangible income, defined similarly to the Option C definition, derived by the U.S. corporation in the active conduct of a trade or business in the United States – at half the normal corporate tax rate.[67] The Discussion Draft Summary describes the coupling of a reduced tax rate on foreign intangible income with a new category of subpart F income for all intangible income of CFCs as a carrot-and-stick approach to taxing intangible income.[68] The Enzi proposal's coupling of its new low-taxed subpart F category with the halving of the corporate tax rate on foreign intangible income of U.S. corporations

[66] *Discussion Draft, supra* note 51, section 331C.

[67] United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 103. The rate reduction is provided by a deduction for 50 percent of a corporation's qualified foreign intangible income. Certain income, including payments under cost sharing arrangements and amounts treated as received by the U.S. corporation under the section 367(d) commensurate-with-income requirement, is not eligible for the rate reduction. *Id.*

[68] *Discussion Draft Summary, supra* note 63, at 2.

likewise can be thought of as a carrot-and-stick approach. In both cases, the carrot is a reduction in the U.S. tax burden on cross-border intangible income motivated by the broad concern that the current U.S. tax rules impose excessive taxation on the foreign income of U.S. MNCs relative to the home-country tax burdens faced by foreign MNCs.

This broad concern underlies the larger international tax reform bills that include Option C and the Enzi proposal. Both Chairman Camp's Discussion Draft and Senator Enzi's legislation would move the United States to territorial-style, or dividend exemption, regimes of international taxation under which foreign business income derived by CFCs would be largely exempt from U.S. taxation when repatriated to U.S. parent companies through dividends.[69] A background document released with the Discussion Draft justifies the shift to a dividend exemption system as a way of equalizing the tax treatment of U.S. and foreign firms when those firms operate across borders:

> A key component of the House Republican tax reform plan is shifting from a "worldwide" system of taxation – which double taxes American companies when they attempt to compete with foreign companies in overseas markets – to a more competitive, pro-job creation "territorial" tax system that puts our companies on a level playing field with foreign competitors.[70]

Senator Enzi also has argued for his legislation based on competitiveness:

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[69] Both bills allow a domestic corporation a deduction for 95 percent of a dividend received from a CFC out of the CFC's foreign-source income. S. 2091, § 101; *Discussion Draft*, *supra* note 51, § 301. The Discussion Draft brackets the 95-percent amount to indicate flexibility about the exemption level in future legislative developments.

[70] HOUSE COMMITTEE ON WAYS AND MEANS, REFORMING THE TAX CODE TO GET AMERICA WORKING AGAIN, *at* http://waysandmeans.house.gov/uploadedfiles/international_2_page_final.pdf (last visited Sept. 30, 2012).

> Enacted in the 1960s, our current international tax rules have passed their expiration date. Many of the United States' major trading partners, including Canada, Japan, and the UK, have moved to what are called "territorial" tax systems. . . . The bill I'm introducing today would help to right the ship by pulling our international tax rules into the 21st century so that U.S. companies are not at a competitive disadvantage with foreign companies because of American tax rules, outdated by changes most other countries have already made.[71]

A specific concern of the taxpayer-favorable elements of Option C and the Enzi proposal – to avoid overly burdensome taxation of U.S. MNCs' intangible income by comparison with the taxation imposed by foreign countries on foreign MNCs – therefore can be understood as part of the broader policy of the bills in which the intangibles rules are included. Chairman Camp and Senator Enzi have articulated this broader policy in the language of capital import neutrality that has featured prominently in the international tax debates of the last five decades.

Encouraging U.S. research

The taxpayer-favorable elements of Option C and the Enzi proposal are also motivated by another policy not described previously in this article. That policy is that the tax rules should encourage U.S.-based research activities. Like the two dueling policies already discussed, incentives for U.S. research have long-established precedents in the tax law. The Discussion Draft Summary refers to the reduced rate of tax on foreign

[71] 158 Cong. Rec. S497-98 (daily ed. Feb. 9, 2012) (statement of Sen. Enzi), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2012-02-09/pdf/CREC-2012-02-09.pdf [hereinafter *Enzi Floor Statement*].

intangible income derived by CFCs and U.S. parent companies as an "innovation box."[72] In introducing his legislation, Senator Enzi said, "[T]his bill would reduce the U.S. tax burden on income generated by American companies from ideas and inventions. This bill would encourage companies to develop and keep rights to ideas and inventions in the United States."[73]

Senator Feinstein and Representative Schwartz share the view that the tax rules should encourage the development of "ideas and inventions" in the United States. Senator Feinstein has publicly announced plans to introduce a bill that would tax corporations on income from the sale of patented products manufactured in the United States at a 15-percent rate rather than at the normal 35-percent corporate tax rate.[74] Among the arguments that she has offered in favor of the Feinstein patent box is that a so-called patent box would "increase returns to investments in research and development."[75] The Schwartz patent box taxes at a 10-percent rate a taxpayer's high returns from, among other things, selling, leasing, or licensing in its trade or business

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[72] *Discussion Draft Summary*, *supra* note 63, at 2. Over the last decade, several European countries have enacted preferential tax regimes for patent and other intellectual property income. It is thought that the regimes have been referred to as "patent boxes" because the income qualifying for reduced taxation is in a separate box for reporting purposes. For a description of European patent box systems, *see* Peter R. Merrill et al., *Is It Time for the United States to Consider the Patent Box?* 134 Tax Notes 1665 (2012). The Discussion Draft Summary refers to an "innovation" rather than "patent" box as a way of signaling that Option C's reduced tax rate for foreign intangible income applies broadly to all intangible income, not just to patent-related income.

[73] *Enzi Floor Statement*, *supra* note 71, at S497.

[74] DIANNE FEINSTEIN, PUTTING AMERICA BACK TO WORK, *at* http://www.feinstein.senate.gov/public/index.cfm/putting-america-back-to-work (last visited Sept. 30, 2012) [hereinafter *Back to Work*].

[75] *Id.* The Feinstein patent box also is intended to encourage U.S. manufacturing, and much of the justification for the bill is described in terms of encouraging both U.S. innovation and manufacturing.

properties in which patents are used.[76] The amount of a taxpayer's income qualifying for the 10-percent rate increases as the taxpayer's research expenses increase as a proportion of its overall costs.[77] According to Representative Schwartz's press release accompanying introduction of the bill, one reason why Congress should pass the bill is "to promote research and development by incentivizing companies to hire American scientists and researchers."[78]

The policy goal of encouraging U.S. research owes in part to anxiety that the United States is losing its global position as a source of research and innovation.[79] Like the dueling policy goals of the excess returns proposal, Option C, and the Enzi proposal, anxiety over America's position in the world and a desire to use the tax code to prevent a perceived slide is not new. When Congress passed the original version of the research and experimentation tax credit (which expired at the end of 2011 but which, like the previously described CFC look-through rule, stands a chance of being extended retroactively) in 1981, it was motivated by similar concerns.[80] The research credit is a tax

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[76] Manufacturing American Innovation Act of 2012, H.R. 6353, 112th Cong. § 2 (2012). In broad terms, high returns are defined as profits in excess of a "routine profit," which is defined as a 15-percent mark-up on certain allocable costs.

[77] *Id.*

[78] ALLYSON Y. SCHWARTZ, THE MANUFACTURING AMERICAN INNOVATION ACT: A NEW WAY OF THINKING IN CORPORATE TAX POLICY, *at* http://schwartz.house.gov/press-release/manufacturing-american-innovation-act-new-way-thinking-corporate-tax-policy-0 (last visited Sept. 30, 2012).

[79] *See, e.g.*, *Back to Work*, *supra* note 74 ("Manufacturing jobs across the country — both blue- and white-collar — continue to be offshored, and the effects are dire. Not only does the U.S. employment base continue to suffer, but companies are experiencing a significant decline in innovation, a byproduct of a strong manufacturing industry. . . . The United States cannot sit on the sidelines while our economic competitors aggressively market themselves through lucrative incentive programs. Doing nothing is a tacit acknowledgment that America is content becoming a second-rate innovator and manufacturer.").

[80] The regulations for the allocation and apportionment of research and experimentation expenditures (described previously in note 33), which took effect in 1995, also can be understood as part of a recurrent tax policy goal of encouraging U.S. research. These regulations are not explicitly an incentive but may operate as one: If a taxpayer engages in a sufficiently high proportion of its research activities in the United States, it can automatically treat half of its research expenses as reducing U.S.-source, not foreign-

credit for wages, supplies, contract research expenditures, and certain other amounts paid in connection with a trade or business for qualified research undertaken in the United States or any U.S. territory such as Puerto Rico.[81] The credit is generally equal to 20 percent of the amount of qualified research expenses to the extent that amount exceeds a base period amount.[82] The Ways and Means Committee report accompanying the original version of the credit in 1981 provided the following rationale for the credit:

> The committee believes that a substantial tax credit for incremental research and experimental expenditures will overcome the resistance of many businesses to bear the significant costs . . . which must be incurred in initiating or expanding research programs. . . . Aggregate research and development spending in this country has experienced a . . . period of decline. In 1967, total expenditures reached a high of 2.91 percnet of GNP before declining over ten years to 2.26 percent in 1977, and then

source, income, thereby leaving its foreign tax credit limitation unaffected by that half of the expenses even though those expenses arguably generate foreign income – for example, royalties that a foreign affiliate pays for a license to use intangible property such as a patent in its foreign business.

Notwithstanding that the 50-percent exclusive U.S. apportionment rule may operate as an incentive, the Treasury Department promulgated the rule in 1995 for the stated reason that the rule more accurately reflected the relationship between U.S. MNCs' U.S. research and development activities and their foreign income than the previous rule. That earlier rule, which dated to 1977, permitted a 30-percent exclusive apportionment of research expense to U.S.-source income. The increase from 30-percent to 50-percent exclusive U.S. apportionment followed a Treasury Department study that concluded that although the 30-percent exclusive apportionment rule overall could be seen as accurately reflecting the factual relationship between domestic research expenditures and foreign income, in some cases this rule could be unfair to taxpayers. The study therefore recommended decreasing the apportionment to foreign income by about 25 percent, and the 1995 regulations carried out this reduction. *See* DEPARTMENT OF THE TREASURY, THE RELATIONSHIP BETWEEN U.S. RESEARCH AND DEVELOPMENT AND FOREIGN INCOME (1995).

[81] I.R.C. § 41.

[82] *Id.* § 41(a). The excess-over-base-period rules are intended to restrict the research credit to taxpayers that increase their research expenditures over time. In lieu of the 20-percent credit for expenditures over a base period amount, a taxpayer may elect the so-called "alternative simplified credit." The amount of that credit is 14 percent of the taxpayer's qualified research expenses in excess of 50 percent of the taxpayer's average qualified research expenses for the three preceding years. *Id.* § 41(c)(5).

> increasing to an estimated 2.30 percent in 1980. If military and space research expenditures are subtracted from the total, the "civilian" research/GNP ratio for the United States is 1.5 percent, compared with 1.9 percent for Japan and 2.3 percent for West Germany. The committee believes that the decline in this country's research and development activities has adversely affected economic growth, productivity gains, and our competitiveness in world markets.[83]

In putting forward their various proposals, Chairman Camp, Senators Enzi and Feinstein, and Rep. Schwartz have repeated the sentiments expressed 30 years ago that America is losing its lead in research and innovation, that the tax code can be used to arrest this perceived slipping, and that increased research will spur job creation and economic growth.

IV. Departures

The five recent proposals related to the taxation of intangible income arise from longstanding congressional policy concerns. In this sense they represent incremental rather than fundamental change.[84] The proposals, though, include at least two significant features that have no close analogs in existing law. Option C and the Enzi proposal hinge tax treatment of intangible income on whether the income is derived from serving U.S. or foreign markets. This distinction based on whether customers are in the United States or abroad provides what might be termed destination-based income taxation. The excess returns proposal and the Schwartz patent box provide formulas for determining whether,

[83] H.R. Rep. No. 97-201, at 111 (1981).

[84] As noted previously, the international tax bills in which Option C and the Enzi proposal are included provide thoroughgoing reform.

and the extent to which, income is subject to immediate rather than deferred U.S. taxation (in the case of the excess returns proposal) or reduced U.S. taxation (in the case of the Schwartz patent box). These destination-based and formula-based features raise questions about two central elements of the accepted structure of cross-border income taxation, source-based taxation and arm's-length transfer pricing. The destination- and formula-based rules also suggest possible new directions for U.S. international tax rules.

In one significant departure from the structure of most current U.S. international tax rules, Option C and the Enzi proposal provide a dual-rate, destination-based method of taxing intangible income, with intangible income derived from serving foreign markets taxed at a lower rate than intangible income from serving the U.S. market. Option C's destination-based rule taxes a U.S. parent company at a 15-percent rate on foreign intangible income and at the general 25-percent corporate tax rate on intangible income derived from serving the U.S. market.[85] This destination-based tax applies whether the CFC or the U.S. parent company derives the income. The Enzi proposal's somewhat similar destination-based rules tax a U.S. parent company at half the normal U.S. corporate tax rate on foreign intangible income that it derives in the conduct of a U.S. trade or business; the rules maintain full U.S. taxation of a U.S. parent corporation's domestic intangible income.[86]

[85] As described previously, foreign intangible income is intangible income derived in connection with (1) property that is sold for use, consumption, or disposition outside the United States or (2) services provided with respect to persons or property located outside the United States. *Discussion Draft,* supra note 51, at § 331C.

[86] Unlike Option C, the Enzi proposal does not create parity between the taxation of intangible income derived by CFCs and the taxation of intangible income derived by U.S. parent corporations. The Enzi proposal taxes currently at the full U.S. corporate tax rate intangible income that is derived by CFCs and is subject to a low foreign tax rate, whether the income is from serving the U.S. or a foreign market. *See* United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 201 (2012).

In another departure from the structure of most existing U.S. international tax rules, the formula-based rules of the excess returns proposal and the Schwartz patent box provide unfavorable (in the case of the excess returns proposal) or favorable (in the case of the Schwartz patent box) tax treatment of targeted income only to the extent the income satisfies formulas that measure cost-based returns. The excess returns proposal taxes currently under subpart F U.S.-connected intangible income to the extent the income in question is in excess of 150 percent of the costs properly attributable to the income. The Schwartz patent box allows its reduced 10-percent tax rate to patent-related income only to the extent the income exceeds a "routine profit" equal to a mark-up of 15 percent over certain costs properly allocable to the income.

Neither the destination-based rules of Option C and the Enzi proposal nor the formula-based rules of the excess returns proposal and the Schwartz patent box have close analogs under current law. The foreign base company sales and services income rules of current law, which might be the closest parallels to the destination-based rules of Option C and the Enzi proposal, are destination-based in the sense that they create current U.S. taxation under subpart F only of a CFC's income from sales for use and services performed outside the CFC's country of organization. But the current foreign base company rules are much narrower than the destination-based rules of Option C and the Enzi proposal because the former apply only in the context of related party transactions and only when taxpayers fail certain exclusions (such as the manufacturing exception from foreign base company sales income and the objective cost test under the substantial assistance prong of the foreign base company services income rules), whereas the dual-rate, destination-based structures of Option C and the Enzi proposal provide destination-based tax rates for much of a U.S. MNC's intangible income (both CFC and U.S. parent company income in the case of Option C; U.S. parent company income in the case of the Enzi proposal), in respect of both related and unrelated party transactions.

The nearest current law precedent for the formula-based features of the excess returns proposal and the Schwartz patent box might be the transfer pricing regulations' residual profit split method of evaluating whether the allocation of related parties' combined profits attributable to particular transactions is arm's length.[87] This residual profit split method allocates profits among related taxpayers by first giving each taxpayer a market rate of return on its routine contributions to the relevant business activity and then dividing the residual profit, if any, based on each taxpayer's non-routine contributions – particularly of intangible property.[88] This two-step allocation of routine returns and residual profits parallels the excess returns proposal's and Schwartz patent box's identification of threshold levels of returns on costs below which the proposals do not apply. Unlike the excess returns proposal and the Schwartz patent box, however, the residual profit split method does not prescribe a particular profit margin that is considered routine.[89] That determination is instead made on a case-by-case basis by reference to market returns in unrelated-party transactions.

[87] *See* Treas. Reg. § 1.482-6(c)(3).

[88] *Id.*

[89] By contrast with the residual profit split method of the transfer pricing regulations, the expired Puerto Rico and possession tax credit's optional profit split method for allocating income to a possession corporation did prescribe a percentage allocation. *See* I.R.C. § 936(h)(5)(c)(ii). Unlike the possession tax credit's default income allocation rules, the optional profit split method (and the other optional method, the cost sharing method) permitted taxpayers to claim the tax credit in respect of intangible income. A taxpayer that satisfied certain significant presence and manufacturing or production requirements in respect of a possession business could elect to use this profit split method to allocate to its possession corporation 50 percent of its affiliated group taxable income (including intangible income) from the sale of a product or the provision of a service related to the possession business, thereby making this allocated income eligible for the credit against U.S. tax. *Id;* Treas. Reg. § 1.936-6(b).

The destination-based and formula-based features of the recent legislative proposals challenge the primacy of arm's-length transfer pricing and source-of-income rules in the structure of cross-border income taxation. Under the current structure of international taxation, the division among different countries of the primary right to tax cross-border income streams of MNCs can be thought of as involving two steps in which transfer pricing and source determinations are central. In the first step, arm's-length transfer pricing determines the allocation of income among legal entities in the MNC group. In the second step, after income has been properly allocated among legal entities, source-of-income rules determine the country of origin of each item of income of each entity in the MNC group.

This source determination, in turn, has substantive tax consequences for each entity. When a company that is a resident of one country derives income from another country, under broadly accepted principles of international taxation one country (the country of residence of the taxpayer) or the other (the country in which the income has its source) might assert primary right to tax the income based on either the taxpayer's residence or the source of the income. Much cross-border investment income is taxed on a residence basis (that is, by the country of residence of the taxpayer deriving the investment income), and much cross-border business income is taxed on a source basis (that is, by the country in which the business income originates).[90] For example, under

This optional profit split method therefore shared the formula-based nature of the excess returns proposal and the Schwartz patent box, but the latter two proposals are potentially much more broadly applicable than the profit split method of the possession tax credit: The excess returns proposal creates potential U.S. tax for any U.S. MNC that derives intangible income through a CFC, and the Schwartz patent box offers a low rate of tax to any taxpayer that has patent-related non-routine profits. The optional profit split method was available only to a subset of U.S. MNCs that had business operations in a U.S. territory.

[90] For a description of this dichotomy, *see* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301 (1996).

bilateral income tax treaties, the business profits of a resident of one treaty country attributable to that resident's permanent establishment in the other treaty country (the source country) may be taxed by the source country, and the residence country is required to relieve double taxation by exempting the profits from tax or allowing a credit for source country tax.[91]

In various ways, the destination-based rules of Option C and the Enzi proposal and the formula-based rules of the excess returns proposal and the Schwartz patent box disrupt this transfer-pricing-based and source-based taxation of cross-border intangible income. Transfer pricing matters to the taxation of a U.S. MNC's intangible income under current law because a transfer pricing allocation of the intangible income to a CFC often means that the income is subject to U.S. taxation, if at all, only when the income is repatriated to the U.S. parent company. As one example of why sourcing of intangible income matters under present law, recall that treating a U.S. parent company's royalty income as foreign-source helps the company with its foreign tax credit planning.[92] Option C is the most direct of the four proposals in reducing the significance of transfer pricing and source determinations. It diminishes the importance of transfer pricing because the rate of U.S. tax imposed on a U.S. MNC's intangible income varies not based on the transfer pricing allocation of the income to one entity or another in the group, but instead based on whether the income – whether allocated to the U.S. parent company or to a CFC – is from serving the U.S. or a foreign market. Option C similarly diminishes the importance of source-based taxation because source has no role in determining the tax

[91] *See* U.S. Model Income Tax Convention of November 15, 2006, Articles 7 (Business Profits), 23 (Relief from Double Taxation).

[92] For this discussion, *see* notes 29 – 33 and the accompanying text.

rate on a U.S. MNC's intangible income; the question, instead, is whether the income is from sales or services to the United States or abroad.

The destination-based feature of the Enzi proposal similarly makes transfer pricing and source determinations less central to the taxation of U.S. MNCs' intangible income than those determinations are now. For a U.S. MNC with intangible income, a central question under the Enzi proposal is whether the income is from serving the U.S. market or a foreign market because income from serving the U.S. market benefits from a 50-percent tax rate reduction. As a result, a transfer pricing allocation of intangible income to the U.S. parent rather than to a CFC penalizes a U.S. MNC less than it does under the current law full taxation (less foreign tax credits) of intangible income of U.S. parent companies.[93] And source becomes less central because the U.S. or foreign source of a U.S. parent company's intangible income matters not at all to the availability of the 50-percent rate cut.

The formula-based feature of the excess returns proposal broadens current law subpart F's contravention of the consequences of arm's-length transfer pricing. Under current law, transfer pricing allocations of income to CFCs are largely irrelevant if subpart F causes current U.S. taxation of the income. Subpart F, however, has limited application to business income under current law because the foreign base company sales and services income rules, the rules under which business income might be considered subpart F income, apply only to income from certain related-party, cross-border sales and services transactions, and through planning U.S. MNCs often can avoid having foreign

[93] In fact, under the Enzi destination-based feature, an allocation to the U.S. parent rather than to the CFC benefits a U.S. MNC if the intangible income in the hands of the CFC would have been subject to full, current U.S. taxation under the new subpart F category for low-taxed income.

base company sales or services income. The excess returns proposal may expand subpart F's contravening of the results of arm's-length transfer pricing allocations to a much broader category of income: Any high-return intangible income of a CFC is caught if it is attributable to U.S.-connected intangible property and is subject to a low rate of foreign tax.

The Schwartz patent box does not so directly contravene arm's-length transfer pricing, but it shares the excess return's proposal's suspicion of the arm's-length standard. The Schwartz patent box allows its reduced tax rate only to patent-related profits in excess of a 15-percent mark-up over certain allocable costs. As an alternative to this formula-based approach, the bill allows a taxpayer to elect to calculate its patent-related profits by reference to arm's-length transfer pricing principles – but only in accordance with guidance provided by the Treasury Secretary. Rep. Schwartz could have chosen to, but did not, make this arm's-length calculation the default rule for determining patent-related profits. Her contrary choice of a formula-based approach as the default suggests an uncertainty about the consequences of applying arm's-length transfer pricing in calculating the amount of income attributable to intangible property.

By challenging the primacy of source of income and arm's-length transfer pricing principles, the destination-based and formula-based proposals suggest possible new directions for the U.S. international tax rules. None of the five recent proposals makes significant changes to the source rules or the transfer pricing rules.[94] Commentators,

[94] Senator Enzi's bill changes to U.S.-source any income from the sale of inventory property that would be foreign source under section 862(a)(6) or 863(b)(2). S. 2091, § 213. Another recent Obama Administration proposal modestly revises the transfer pricing rules. *See* DEPARTMENT OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 90 (2012) (proposal to clarify certain scope and valuation matters related to the commensurate-with-income rules of sections 367(d) and 482).

however, have long noted the difficulties of assigning sources to various income streams.[95] And criticism of the arm's-length-based transfer pricing rules is long-standing and legion.[96] It is, therefore, conceivable that as part of international tax reform Congress could decide to revise the source rules or even the transfer pricing rules. Equally plausible is that Congress could implement, more or less broadly, the destination-based principle, the formula-based principle, or some combination of the two principles.

Policy makers might find destination-based principles an attractive means of addressing intertwined policy objectives.[97] For example, Congress might disapprove of the practice of manufacturing products abroad and selling those products in the United States. Conversely, Congress might approve of the practice of manufacturing in the United States and selling abroad. Congress could pursue these objectives by taxing MNCs on income from products imported into the United States and allowing MNCs not

[95] A League of Nations report that became a foundational document in the development of the modern international taxation concepts of residence and source uses the example of a tea plantation in Java to illustrate the ambiguity of the concept of source: What is the source of income, the example asks, when the growing of the tea, the management of the enterprise, the transportation of the tea, and the sales to customers take place in multiple countries. *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp,* League of Nations Doc. E.F.S.73 F.19 (1923) at 23-24. For a more recent description of the ambiguity of the concept of source, see Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises, in* TAXATION IN THE GLOBAL ECONOMY (Assaf Razin & Joel Slemrod eds, University of Chicago Press, 1990) ("The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea.").

[96] For older criticisms, *see* Guenter Schindler and David Henderson, *Intercorporate Transfer Pricing: 1985 Survey of Section 482 Audits,* 29 TAX NOTES 1171 (1985); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length,* 30 TAX NOTES 625 (1986).

[97] In a different context, an academic economist has proposed a destination-based, cash-flow (or consumption) corporate tax. Alan J. Auerbach, *A Modern Corporate Tax* (Center for American Progress & The Hamilton Project, 2010), *available at* http://www.americanprogress.org/wp-content/uploads/issues/2010/12/pdf/auerbachpaper.pdf (last visited October 5, 2012). Auerbach argues that his tax would promote domestic corporate activity and U.S. investment, thereby increasing productivity.

to pay tax on income from domestically produced products sold abroad.[98] Or Congress could adopt one of those two rules but not the other.[99]

Destination-based schemes could be coupled with formula-based elements. For example, if a primary concern is erosion of the U.S. tax base when U.S. MNCs engage in product development activities such as research in the United States but arrange to route high returns from product sales through foreign affiliates, U.S. taxation of income from sales and services for the U.S. market could be limited to situations in which the income is high-margin. By the same logic, if Congress wanted to encourage MNCs to locate in the United States high-value-added activities related to exports of sales and services, it could allow an exemption for foreign sales and services income only to the extent that income was high-margin income attributable to the desired U.S. activities.

Congress also could use formula-based rules by themselves to address large policy concerns. If a concern is that the current U.S. international tax rules do not properly allocate high returns generally, whether from intangible or tangible property, Congress could broaden the excess returns proposal's formula-based principle so that, as one possibility, all a U.S. MNC's income above a chosen rate of return, whether derived by a CFC or the U.S. parent company, is taxed by the United States as it is earned. A

[98] This broad application of the destination-based principle would resemble the single-factor formulary apportionment schemes adopted by many U.S. states. For an article advocating single-factor formulary apportionment of the income of U.S. MNCs, *see* Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, The Hamilton Project Discussion Paper 2007-08 (The Brookings Institution, 2007), *available at* http://www.brookings.edu/~/media/Research/Files/Papers/2007/6/corporatetaxes%20clausing/200706clausing_aviyonah.PDF (last visited Oct. 4, 2012). Many policy makers might view broad application of principles that resemble formulary apportionment as too radical a departure from current norms.

[99] For several years there have been legislative proposals to tax U.S. MNCs on income from imported property. *See, e.g.*, SA 3110 (Sen. Dorgan), proposed amendment to S. 1637, 108th Cong (2004) (creating a new category of foreign base company income for "imported property income"). The imported property income proposal has been introduced most recently in the Offshoring Prevention Act, S. 45, 112th Cong. (2012).

corollary of this approach might be that the United States would forgo current U.S. taxation of all of a CFC's business income below the chosen rate of return. These formula-based approaches could be adopted in the absence of large-scale international tax reform or could be part of the switch from a foreign tax credit to an exemption method of relieving U.S. tax on foreign income. In that latter case, the different tax treatment of high returns and routine returns would be current U.S. taxation versus no U.S. taxation rather than, if adopted under present law, current U.S. taxation versus deferred U.S. taxation.

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A serious normative evaluation of these destination-based and formula-based departures is beyond the scope of this article. A couple broader observations may bring the discussion back to a matter alluded to near the beginning of this article in the description of intangible income embedded in profits from, as one of the examples, sales of Tide laundry detergent: There is no easy, precise way to tease out Procter & Gamble's income attributable to Tide's marketing intangibles from income attributable P & G's investment in the plant that produces the detergent. A formula that deems income to be intangible income to the extent it exceeds a prescribed rate of return on a taxpayer's investment in tangible capital eliminates uncertainty about what is and is not intangible income, but it does so at the arguable risk of imprecision. The formula-based rules of the excess returns proposal and the Schwartz patent box likewise might ease the difficulty of identifying intangible income. Those rules, however, leave in place the challenge of determining whether (in the case of the excess returns proposal) the returns in question bear the necessary factual relationship to intangible property transferred by a U.S. person to a related CFC or (in the case of the Schwartz patent box) the non-routine profits bear the necessary factual relationship to patented property.

This last observation raises the question whether the character of income as attributable to patents, secret formulas, or other intangible property implicates any policy concerns that are distinct from policy concerns related to high returns generally. If the policy objective at issue is to encourage U.S. research, the answer to this question might be that high returns alone, irrespective of a connection to intangible property, should not qualify for a tax preference. If they did, a taxpayer operating a gold mine when gold prices are high might be eligible for the preference. If the concern instead is protecting the U.S. tax base or avoiding competitive problems for U.S. MNCs, then maybe there is nothing special to intangible property income apart from its tendency to be high-margin.

If Congress applied destination-based or formula-based principles broadly, other questions would arise. Compliance and administration related to destination-based principles in an income tax may be difficult because when a taxpayer derives income that is taxed on a destination basis, it may have no easy way of knowing the place of use of the goods or services to which the income is attributable, particularly when there are multiple stages in the production process involving both related and unrelated parties.[100] More fundamentally, notwithstanding possible merits of the objectives underlying adoption of those principles, the coexistence of arm's-length transfer pricing and source-based taxation with principles that undercut those fundamental features of the U.S. international tax system could decrease the coherence of a system that already embodies

[100] A destination-based value added tax may create lower compliance and administration burdens because a VAT applies on a transaction basis at each stage of production. Tax administrations have nonetheless contended with VAT evasion at the border through so-called "carousel fraud" schemes.

the significant tensions in Congress's varying policies over time. On the other hand, avoiding possible incoherence by overhauling the transfer pricing and source rules would be an ambitious endeavor that, because of the bilateral and multilateral nature of transfer pricing and source questions, would have direct effects across borders.