General Explanation of the Tax Reform Act of 1986, Pub. L. 99-514; 99th Cong., H.R. 3838 (JCS-10-87)

Transfers of intangibles to related parties (sec. 1231 of the Act and secs. 367, 482, and 936 of the Code) fn16 *Prior Law and Background In general* A U.S. taxpayer may transfer intangible property or rights to use such property to a related corporation that is not subject to current U.S. tax because the related corporation is a foreign corporation or an electing section 936 corporation. (Foreign corporations generally are not subject to U.S. tax unless they receive U.S. source income or have a U.S. business; special rules are provided for electing section 936 corporations that allow them generally not to pay U.S. tax). Various provisions of the Code have attempted to limit the ability to obtain deferral or effective exemption of income attributable to the intangible by shifting the income from a U.S. taxpayer to a related entity not subject to U.S. tax.

Section 482

A related party license or sale of rights to use property is generally subject to the provisions of section 482 of the Code. That section authorized the Treasury Department to allocate income among related parties as necessary to prevent the evasion of taxes or clearly to reflect the income of such parties. Treasury Regulations under section 482 have interpreted this provision by attempting to determine what an arm's length charge between unrelated parties would have been. Following this approach, the regulations have provided that appropriate allocations of income to reflect an "arm's length" consideration may be made if intangible property is transferred on other than arm's length terms. To determine an arm's length consideration, the regulations have looked to comparable transactions where they exist, and particularly to transfers by the same transferor to unrelated parties involving the same or similar property under the same or similar circumstances. Where a sufficiently similar transaction with unrelated parties cannot be found, prevailing rates in the industry and bids of other parties, as well as prospective profits to the transferee, are among the factors that may be considered under the regulations. None of the factors has been accorded special emphasis. Depending on the circumstances, an arm's length consideration may have taken the form of a stated royalty or lump sum payment. Other methods of allocation could also be appropriate, depending on the circumstances.

Section 367

Where the U.S. taxpayer does not transfer the right to use the intangible to its foreign affiliate in the form of a license or sale, but rather as a transfer of the ownership of the intangible through a contribution to capital, the transfer is subject to section 367. Under that section, transfers of appreciated property, including intangibles, to related foreign corporations by a contribution to capital or similar transaction that would be tax free if made to a U.S. corporation were prior to 1984 generally treated as taxable sales where the transfer had as one of its principal purposes the avoidance of U.S. tax.
The Internal Revenue Service took the position that transfers to foreign corporations of patents, trademarks and similar intangibles for use in connection with a U.S. trade or business, or for use in connection with manufacturing for sale or consumption in the United States, generally had tax

avoidance as a principal purpose and would be subject to a "toll" charge under section 367. Rev. Proc. 68-23, 1968-1 C.B. 821. By negative implication, transfers for use purely in connection with a foreign trade or business or manufacturing might have been viewed as nontaxable. In response to the substantial tax advantages available to taxpayers if they could transfer intangibles to related foreign corporations without a toll charge, as a contribution to capital without the payment of any royalty or any allocation of income, Congress amended section 367(d) in 1984 to provide that except as provided in regulations, a transfer of intangibles to a foreign corporation as a contribution to capital under section 351 or in a reorganization under section 361 would be treated as a sale of the intangibles. Intangibles for this purpose include any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) any similar item, which property has substantial value independent of the services of any individual. Section 367(d) has provided that the amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. In general, the amounts are treated as received over the useful life of the intangible property on an annual basis. Thus, a single lump-sum payment, or an annual payment not contingent on productivity, use or disposition, cannot be used as the measure of the appropriate transfer price. Any amounts included in gross income by reason of this special rule are treated as ordinary income from sources within the United States. Section 367 does not apply to transfers to possessions corporations under section 936 because such corporations are U.S. rather than foreign corporations.

Section 936

Because possessions corporations qualifying for the section 936 tax credit are U.S. rather than foreign corporations, section 367 has not applied to transfers of intangibles to possessions corporation by the their U.S. affiliates. Prior to statutory changes made in the 1982 Act, the appropriate treatment of transfers of intangibles to possessions corporations in the form of contributions to capital was not clear. Some taxpayers took the position that such transfers of intangibles could be accomplished without the payment of any consideration or any allocation of income to the U.S. transferor. The Internal Revenue Service challenged this treatment in a number of cases involving transfers of intangibles to possessions corporations that performed manufacturing functions using the intangibles and sold the products back to U.S. affiliates. The Service argues that these transactions in reality constituted contract manufacturing arrangements. Thus, it contends that the income attributable to the transferred intangible should be allocated entirely to the parent under section 482, with the possessions corporation retaining only a return on its manufacturing operations. In the one case decided on this question at the time of the Act, *Eli Lilly and Company and Subsidiaries,* 84 T.C. 996 (1985), the tax court took an intermediate position. While it noted the absence of any royalty or other payment for the intangible, it did not conclude that under the particular facts such a payment would be mandatory. However, on examination of the entire transaction, the court concluded that, taking into account the prices charged on sales of goods back to the U.S. parent, the allocation of income to the parent was too low and that a substantial portion of the profit from the goods manufactured and sold by the possessions corporation should be allocated to the U.S. parent.

If the cost-sharing option is elected, the possessions corporation is treated as the owner of the intangible. However, the principles of section 482 apply in determining the proper selling price of products it produces and sells to its mainland or other affiliate. The principles of section 482 also apply in distinguishing amounts that are attributable to marketing intangibles (such as trademarks, trade names, or corporate knowledge of and contacts with the marketplace) from amounts that are attributable to manufacturing intangibles (such as patents or know-how). *Reasons for Change* There was 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 could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group. Congress was concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations. Many observers have questioned the effectiveness of the "arm's length" approach of the regulations under section 482. A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables. A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries. In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item. The problems have been particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may have transferred such intangibles to foreign related corporations or to possessions corporations at an early stage, for a relatively low royalty, and taken the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently have taken the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items. Certain judicial interpretations of section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing Because of the substantial uncertainty in the area and because it considered the tax advantages claimed by certain taxpayers to be excessive, Congress amended section 936 in 1982 to provide specific rules for the allocation of intangibles income between a possessions corporation and a related entity that transfers intangibles to, or allows their use by, the possessions corporation. Generally, all income attributable to the intangible is taxed directly to the U.S. shareholders unless one of two specified options is elected. One option is a 50/50 profit split under which 50 percent of the profit is allocated to the U.S. parent. The other option is a cost-sharing option, under which the possessions corporation can claim a return on manufacturing (but generally not marketing) intangibles related to the products it produces if it makes a "cost-sharing" payment to its affiliates computed under a specified formula. *fn17 fn18 fn19*

This approach applies both to outright transfers of the ownership of the intangibles (whether by sale, contribution to capital, or otherwise), and to licenses or other arrangements for the use of intangibles. In making this change, Congress intended to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. In determining whether the taxpayer could reasonably expect that projected profits would be greater than the industry norm, Congress intended that there should be taken into account any established pattern of transferring relatively high profit intangibles to U.S. possessions or low tax foreign locations. Congress did not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus, Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in the arrangements, even though there are significant differences in the volume and risks involved, or in other factors. *See, e.g., United States Steel Corporation v. Commissioner,* 617 F. 2d 942 (2d Cir. 1980). While Congress was concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believed that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles was necessary. In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. The transferor may well be looking in part to the value of its direct or indirect equity interest in the related party transferee as part of the value to be received for the transfer, rather than to "arm's length" factors. Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases. Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. Congress thus concluded that it is appropriate to assure that the division of income between related parties reasonably reflect the relative economic activities undertaken by each. Congress believed that payments made on a transfer of intangibles to a related foreign corporation or possessions corporation should be commensurate with the income attributable to the intangible. With respect to possessions corporations electing the cost-sharing option under section 936, Congress was concerned that the cost-sharing payment computed under prior law may not always have allocated sufficient income to mainland affiliates with respect to manufacturing intangibles the possessions corporations were treated as owning under that option. The option looks to a sharing of costs that may be insufficiently related to the highly profitable intangible actually transferred. Congress believed that an appropriate floor for the cost-sharing payment is the royalty the possessions corporation would pay under section 482 or 367 principles, were they applicable with respect to such manufacturing intangibles.

Explanation of Provisions

The basic requirement of the Act is that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. This requirement is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each.

income attributable to the intangible. The Act is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible. In requiring that payments be commensurate with the income stream, the Act does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under prior law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight. The requirements of the Act apply when intangibles of the type presently subject to section 367(d) are transferred by a U.S. person to a related foreign entity or to a possessions corporation that elects the cost-sharing option, or are licensed or otherwise used by such entity. Thus, the standard that payments must be commensurate with the income attributable to the intangible applies in determining the amounts to be imputed under section 367(d) and in determining the appropriate section 482 allocation in other situations. The standard also applies in determining the minimum amount of the "cost-sharing payment" to be made under the cost-sharing option in the case of an electing section 936 corporation. As discussed in greater detail in connection with the changes made by the Act affecting possessions corporations, the Act requires that the cost-sharing payment be at least as great as the royalty the possessions corporation would have to pay to an affiliate under section 367 or 482 with respect to manufacturing intangibles the possessions corporation is treated as owning by virtue of electing the cost-sharing option. In view of the fact that the objective of these provisions - that the division of income between related parties reasonably reflect the relative economic activity undertaken by each - applies equally to inbound transfers, Congress concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account. Congress did not intend to affect present law concepts of what constitutes a single "license", to the extent those concepts are not inconsistent with the purposes of the new provision. Thus, for example, in the case of continuous transfers of technology under a continuing license agreement, the adequacy of the royalty may, in appropriate cases, be determined by applying the appropriate standards under the Act on an aggregate basis with respect to the profitability and other relevant features of the transferred intangibles as a whole. Similarly, Congress did not intend to change principles that would permit offsets or other adjustments to reflect the tax impact of the taxpayer's transactions as a whole. Congress was also aware that many important and difficult issues under section 482 are left unresolved by this legislation. Congress believed that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect. In revising section 482, Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment. *Effective Date* Under the Act, the new provisions generally apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after such date (or before such date with respect to property not in existence or owned by the taxpayer on such date). Congress intended to substitute August 16, 1986 for the November 16, 1985 date in the case of certain transfers not affected by the House bill. *fn20* No inference is intended as to whether the same result could nevertheless be reached under prior law for transfers prior to these effective dates. For purposes of section 936, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made. *Revenue Effect* This provision, apart from its application to possessions corporations, is estimated to increase fiscal year budget receipts by $24 million in 1987, $59 million in 1988, $82 million in 1989, and $108 million in 1990, and $137 million in 1991.

Footnotes:

fn16 For legislative background of the provision, see H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 641; H.Rep. 99-426, pp. 420-427; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 637-638 (Conference Report).

fn17 These provisions are discussed in greater detail in connection with the amendments dealing with section 936 possessions corporations (sec. 1231 of the Act).

fn18 See, *e.g.*, U.S. General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (GGD-81-81, September 30, 1981); Schindler and Henderson, Intercorporate Transfer Pricing 1985 Survey of Section 482 Audits (1985) and materials cited therein. Cf. Department of the Treasury, Internal Revenue Service, *IRS Examination Data Reveal an Effective Administration of Section 482 Regulations*, Report prepared by The Assistant Commissioner (Examinations). April, 1984.

fn19 Schindler and Henderson, *supra* n.18, at p. 6. See GAO report, *supra* n.18.

fn20 H.R. 3838, as reported by the Committee on Ways and Means of the House of Representatives on December 7, 1985. A technical correction may be needed so that the statute reflects this intent.