COMMENTS

of

TAX EXECUTIVES INSTITUTE, INC.

on

REG-159420-04

relating to

Credit for Increasing Research Activities:
Intra-Group Gross Receipts

submitted to

The Internal Revenue Service

March 18, 2014

On December 13, 2013, the Internal Revenue Service (IRS) and Treasury Department released proposed regulations on the treatment of qualified research expenditures (QREs) and gross receipts resulting from transactions between members of a controlled group of corporations or a group of trades or businesses under common control (hereinafter "intra-group transactions") for purposes of determining the credit for increasing research activities under section 41 of the Internal Revenue Code. The proposed rules were published in the December 13, 2013, issue of the Federal Register (78 Fed. Reg. 75905), and the January 6, 2014, issue of the Internal Revenue Bulletin (2014-2 I.R.B. 374). A hearing is scheduled for April 23, 2014.

Tax Executives Institute

Tax Executives Institute is the preeminent association of business tax executives in North America. Our nearly 7,000 members represent approximately 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI represents a cross-section of the business

community, and is dedicated to developing and effectively implementing sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient manner.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises, including the research credit provisions of the Internal Revenue Code. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the proposed regulations under section 174 on the inclusion of intra-group gross receipts in calculating the traditional incremental research credit.

Background

A. *Section 41*

Section 41(a) provides a credit equal to 20 percent of the excess of a taxpayer's qualified research expenditures (QREs) over a base amount (hereinafter "the credit"). The base amount is computed by multiplying the taxpayer's fixed-base percentage calculated during a fixed-base period of years by the taxpayer's average annual gross receipts for the four taxable years preceding the year for which the credit is being determined. The fixed-base percentage is computed by dividing the taxpayer's aggregate QREs by the taxpayer's aggregate gross receipts for the five taxable years beginning after December 31, 1983, and before January 1, 1989. Section 41 does not define the term "gross receipts" for purposes of the credit calculation, but does provide that (i) gross receipts are reduced by returns and allowances, and (ii) in the case of a foreign corporation, only gross receipts effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the

United States (hereinafter a "U.S. trade or business") are to be taken into account. For purposes of calculating the credit, including determining gross receipts, section 41(f)(1)(A) states that "[i]n determining the amount of the credit under this section— (i) all members of the same controlled group of corporations shall be treated as a single taxpayer" (hereinafter the "single taxpayer rule").[1] Domestic and *foreign* controlled corporations are members of the same controlled group for purposes of section 41.[2]

B. *The Proposed Regulations*

The preamble to the proposed regulations states that "the proposed regulations retain the current rule that generally disregards transactions among members of a controlled group for purposes of computing the research credit, but provide a narrow *exception* to this rule."[3] Thus, Prop. Reg. § 1.41-6(i)(2) would require gross receipts from intra-group transactions to be taken into account for purposes of determining the amount of the research credit when "(1) a foreign corporate member engages in a transaction with a party outside of the group (an external transaction) involving the same or a modified version of tangible or intangible property or a service that was previously the subject of one or more intra-group transactions (an internal transaction); and (2) the external transaction does not give rise to gross receipts that are effectively connected with" a U.S. trade or business.[4] Under Prop. Reg. § 1.41-6(ii), the described amount is taken into account in the year the foreign corporate controlled group member engages in the external transaction. To prevent multiple inclusions of gross receipts where transactions involving the same or a modified version of tangible or intangible property or services occur successively between domestic or foreign corporate members, Prop. Reg. § 1.41-

[1] Section 41(c)(7).

[2] Section 41(f)(5).

[3] *See* I.R.B. 2014-2 374 (January 6, 2014), at 375 (emphasis supplied).

[4] *Id.*

6(iii) states that only the last intra-group transaction giving rise to gross receipts is taken into account in the research credit computation. According to the preamble, the proposed "exception" to the single taxpayer rule in section 41(c)(7) "*harmonizes* the application of sections 41(f)(1) and 41(c)(7). . . ."[5] The preamble explains the government's view that if a domestic member of the group incurs research expenditures and sells property to a foreign member of the group and the foreign corporate member then sells the product to a customer that does not give rise to gross receipts effectively connected with a U.S. trade or business, the aggregate amount of gross receipts for determining the research credit is "distorted." The distortion arises "because the QREs of the domestic member are included, but its gross receipts from the sale to the foreign corporate member are not."[6]

Summary of TEI Recommendations

The Institute urges the IRS and Treasury Department to abandon the proposed regulations because they contravene the plain words of section 41 creating a "single taxpayer" rule and undermine congressional intent of providing an incentive for companies to conduct research activities in the United States. Moreover, the proposed rules will impose an onerous, perhaps impossible, administrative burden on taxpayers, requiring them to (1) track all intercompany sales to the final external sale to a third party and (2) reconstruct base period amounts for intercompany transactions in order to comply with the consistency rule of section 41(c)(6).

Discussion

A. *The Proposed Rules Should Be Abandoned*.

1. <u>The statute is clear and does not afford or require a regulatory "exception</u>." The proposed regulations require that certain transactions between members of the same

[5] *Id.* (Emphasis supplied).

[6] *Id.*

controlled group (*i.e.*, transactions between the same taxpayer) be taken into account in determining the amount of gross receipts for the credit calculation. The preamble describes the proposed rules as creating an "exception" to the single taxpayer rule, but asserts that this "exception" harmonizes the application of sections 41(f)(1) and 41(c)(7). Section 41(f)(1), however, states that in determining the amount of the research credit, "*all* members of the same controlled group of corporations shall be treated as a single taxpayer." The single taxpayer rule assures that only third-party transactions, and not intra-group transactions, are taken into account for purposes of calculating the research credit. According to the statute *all members* — both domestic and foreign controlled corporations — are treated as members of the same controlled group (*i.e.*, as the same taxpayer) for purposes of section 41, and nothing in the statute distinguishes between intra-group transactions involving foreign affiliates and intra-group transactions involving solely domestic affiliates. The statute cannot be clearer: all members of the same controlled group of corporations, whether foreign or domestic, are treated as a single taxpayer.

2. <u>The legislative history does not support the creation of a regulatory "exception."</u> The legislative history of the 1989 Act makes clear that Congress considered and retained the single taxpayer rule for purposes of calculating the research credit under the revised statute. The "Explanation of Provisions" section titled "Aggregation rules and changes in business ownership" states that:

> The rules relating to aggregation of related persons and changes in business ownership are the same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

> In addition, . . . a foreign affiliate's gross receipts which are not effectively connected with the conduct of a trade or business in the United States do not enter into the computation of the credit.[7]

Thus, contrary to the statement in the preamble that Congress "did not make clear how sections 41(f)(1) and 41(c)(7) interact," the foregoing excerpt of the explanation of the 1989 statutory changes demonstrates that Congress understood that the single taxpayer rule would be applied in determining the amount of a taxpayer's gross receipts in situations where the "single taxpayer" was comprised of both foreign and domestic controlled corporations. That Congress chose not make an exception to the single taxpayer rule when it made other revisions to the credit computations in 1989 suggests that the most reasonable interpretation of the legislative history is that Congress intended the single taxpayer rule to apply.

As a result, TEI does not believe the proposed regulations are a reasonable interpretation of section 41 because they directly contradict sections 41(f)(1) and 41(c)(7). Rather than harmonize these rules, the proposed regulations create an exception that is unsupported by the plain language of the statute by including a portion of the gross receipts that section 41(c)(7) specifically excludes. The legislative history confirms that Congress understood the interaction between these provisions and intended that all intra-group transactions, as well as receipts derived by a foreign affiliate in a transaction not connected with a U.S. trade or business, should be disregarded in computing the research credit. TEI believes the proposed regulations are inconsistent with congressional intent.

3. Case law does not support the creation of a regulatory "exception." TEI is aware of only one reported decision addressing the issue of the inclusion of intra-group receipts. In *The Proctor and Gamble Company & Subsidiaries v. United States*[8] the IRS asserted that the

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[7] H. Rept. 101-247, at 1202-03 (1989).

[8] 733 F.Supp. 2d 857 (S.D. OH 2010).

taxpayer's intercompany sales to foreign (but not domestic) members of its controlled group should be taken into account in calculating the taxpayer's research credit. In effect, the IRS's litigation position would have produced the same result as would be reached under the proposed regulations. The taxpayer argued that the single taxpayer rule mandates that *all* intra-group transactions, whether from transactions with domestic or foreign affiliates, should be disregarded in calculating the research credit. The District Court agreed with the taxpayer, stating that "the plain language of the statute and regulation is dispositive of this case," and "a discussion of the legislative history of Section 41 of the Internal Revenue Code reveals that P&G's decisions to exclude intercompany transfers with its international members is consistent with the credit's intended incentive effect."[9]

The preamble to the proposed regulations fails to distinguish the *Proctor and Gamble* decision. Indeed, it is unclear how the decision in *Proctor and Gamble* can be reconciled with the proposed regulations. As the court noted in *Proctor and Gamble*, the statute is clear on its face, and thus there is no place for the "exception" created by the proposed regulations. If the regulations are not withdrawn, the final regulations should address and distinguish the *Proctor and Gamble* interpretation.

4. <u>The proposed regulations are not correcting a "distortion" created by the statutory scheme</u>. The preamble to the proposed regulations states that "in most cases, the general rule that disregards intra-group transactions for both gross receipts and QREs furthers the statutory purpose . . . ."[10] The preamble then avers that the inclusion of QREs of a domestic member and

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[9] *Id.* at 865.

[10] I.R.B. 2014-2 374 (January 6, 2014), at 375.

exclusion of gross receipts from the sale to a foreign corporate member results in a "distortion" of the research credit.[11]

TEI submits that the exclusion of a foreign affiliate's gross receipts from the research credit calculation is proper because section 41(d)(4)(F) also excludes foreign research (*i.e.*, any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States) from a taxpayer's QREs. In other words, the U.S. border sets a limit on included activity *and* sales, providing that QREs incurred outside the United States and gross receipts of a foreign corporation that are not effectively connected with a U.S. trade or business are excluded.

In creating an "exception" to the single taxpayer rule, the proposed regulations fail to observe the line drawn by Congress. Indeed, the statute cuts both ways. If a foreign affiliate incurs research expenditures outside the United States and sells an affected product to a domestic affiliate, which then sells the product to a third party, the gross receipts from the domestic affiliate's sale would be taken into account in computing the domestic company's research credit even though the research expenses incurred by the foreign affiliate are not. Since the statute works both ways, it can hardly be said to be "distortive" solely in situations where a domestic affiliate sells a product or service to a foreign affiliate for subsequent sale. The so-called "distortion" is a direct result of Congress's decision not to require taxpayers to trace gross receipts to specific research activities. In effect, the statute provides "rough justice" by excluding from the research credit calculation both foreign research and foreign gross receipts not effectively connected with a U.S. trade or business. In TEI's view, as long as taxpayers are consistent in the base and credit computation years in calculating the research credit, no

[11] *Id.*

distortion is created by the exclusion of a domestic affiliate's receipts from transactions with foreign affiliates that engage in transactions not connected with a U.S. trade or business. If there is a "distortion" — and we do not believe there is — it falls to Congress to amend the statute.

B. *The Proposed Regulations and the Consistency Requirement Impose Onerous Administrative Burdens on Taxpayers*

1. Tracking intercompany sales is an onerous requirement for research credit determinations that the single taxpayer rule is intended to obviate. To prevent multiple inclusions of gross receipts in cases in which transactions involving the same or a modified version of tangible or intangible property or services occur successively between domestic and foreign corporate members, the proposed regulations provide that "only the last internal transaction giving rise to gross receipts (within the meaning of Treas. Reg. § 1.41-3(c)) is taken into account in the research credit computation."[12] As a result, taxpayers must track all intercompany sales from their origin in a domestic member to the ultimate sale to a third party regardless of how many times the property might be sold, or subsequently modified and sold as it moves through various domestic and foreign affiliates in the taxpayer's distribution channel.

TEI believes that Congress purposely chose the rough justice of the current statutory scheme of excluding both foreign QREs *and* sales to foreign members that ultimately produce gross receipts from a non-U.S. trade or business in order to avoid imposing the undue administrative burden created by the proposed regulations. In other words, by retaining the single taxpayer rule in 1989 for all sales, whether to domestic or foreign corporate members, Congress implicitly considered and rejected a requirement that taxpayers trace gross receipts directly to the research activities affecting the products, property, or services. The administrative burden imposed by the proposed regulations' requirement to track goods or services from the first

[12] I.R.B. 2014-2 374 (January 6, 2014), at 376.

domestic member sale to (and through all domestic and foreign corporate members to) the last internal foreign member sale in order to include the gross receipts from that sale in the research credit underscores congressional wisdom.

2. Consistency Requirement. The proposed regulations embody the statutory requirement of consistency in determining a taxpayer's base amount (generally the product of the fixed-base percentage and four-year average annual gross receipts preceding the credit year). As a result, the proposed regulations would require taxpayers to recalculate their gross receipts from the 1984-1988 base period to take account of the effect of the proposed regulations. The preamble helpfully notes that the proposed regulations "are not intended to preclude research credit claims for taxpayers that do not have adequate information in their records for the base years. Accordingly, the IRS and Treasury Department request comments regarding the need for a rule or a safe harbor in applying the consistency requirement. . . ."[13]

TEI appreciates the preamble's statement that the IRS and Treasury Department do not intend to preclude research credit claims for taxpayers that do not have adequate intercompany sales and gross receipts information to support the application of the proposed rules to their base period years. Having said that, if taxpayers do not have the information and documentation for intercompany sales, TEI is uncertain what form a safe harbor might take. In the absence of actual records, the safe harbor would seemingly involve an arbitrary estimate or formula. TEI believes the interaction of the proposed regulations requirement to include the identified gross receipts with the statutory consistency requirement imposes a barrier to compliance that will be nearly impossible for taxpayers to satisfy 25 years after the pertinent portions of the statute were revised.

[13] *Id.*

For the foregoing reasons, TEI believes the proposed regulations impose an onerous burden that is neither justified by the statutory scheme nor administrable. Hence, we urge the IRS and Treasury Department to withdraw the proposed regulations.

Conclusion

Tax Executives Institute appreciates this opportunity to present its views on REG-159420-04 relating to proposed regulations on the treatment of intra-group transactions in the calculation of research credits. If you have any questions about the comments, please do not hesitate to call Gary P. Hickman, chair of TEI's Federal Tax Committee, at (770) 677-2337 or gary.hickman@oldcastle.com or Jeffery P. Rasmussen of the Institute's legal staff at 202.638.5601 or jrasmussen@tei.org.

Respectfully submitted,

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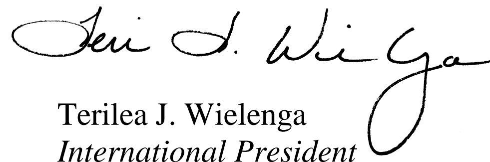

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