9/17/86 Letter commenting on Section 641 of the House Bill on income inclusion when intangibles are transferred or licensed to related possessions corporations and foreign corporations (royalty) sent to the following:

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

cc: The Honorable John J. Duncan
Ranking Minority Member
House Way & Means Committee
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The Honorable Bob Packwood
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The Honorable J. Roger Mentz
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cc: H. Patrick Oglesby, Esq.

TAX SECTION

September 17, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

The Joint Committee on Taxation summary of Final Conference Committee Decisions on the Tax Reform Bill of 1986 indicates that the Conference Committee has adopted Section 641 of the House Bill on income inclusion when intangibles are transferred or licensed to related possessions corporations and foreign corporations.

The House Bill would determine the royalty charged between possessions corporations or foreign entities and a United States transferor on the basis of "payments commensurate with income." This would replace the standard that might otherwise apply under Section 482. The House Ways & Means Committee Report, particularly the third paragraph under "Explanation of Provisions", appears to require that a determination be made for each license for each year. If there has been more than a minor variation in income from sales relating to the particular license, and if there is found to be more than just a minor variation for a year, the royalty for that year must be adjusted "commensurately."

When Section 641 of the House Bill and the accompanying report of the House Ways & Means Committee were discussed earlier this year by the Executive Committee of the New York State Bar Association Tax Section, we noted the Committee's concern that the present intercompany pricing rules being applied under Section 482 raise problems of inadequate compensation to the U.S. transferor (and in some cases inconsistent results also).

We are sympathetic to the difficulties of appropriately pricing the transfer of intangibles from the point of view of both the Treasury and taxpayers. Experience with the present system shows it to be less than perfect. Whether the "payment commensurate with income" concept will prove more satisfactory than the present standards remains to be seen. Given that it is to be tried, however, we do not believe that the practical implementation necessarily requires an annual reexamination and possible revision for each intangible, as the Ways and Means Committee report seems to suggest.

Frequent redeterminations have practical difficulties. One difficulty relates to the increased burdens on the Internal Revenue Service and taxpayers in dealings with each other. Any system which allows for annual redeterminations will require, in effect, an audit of each year to determine whether the condition for an adjustment exists, and if so, the proper magnitude of the adjustment. The increased administrative burden on both Treasury and taxpayers from the additional audit activity and potential corresponding increase in disputes and litigation seems unavoidable.

A second difficulty relates to the increased burdens in dealing with foreign taxing jurisdictions to avoid double taxation. Any royalty adjustment potentially affects not only the United States tax revenues but also the revenues of the tax jurisdiction of the actual or deemed licensee. The effective foreign tax rate on the possessions or foreign corporation will not always be zero. It should not be supposed that the other tax jurisdiction involved will readily agree to an annual royalty adjustment or to adjustments in the same amounts even if annually redetermined (particularly if the change would reduce the revenue collected by the other tax jurisdiction). The more frequent the adjustments by the United States, the greater the likely difficulty in getting acceptance of each adjustment by the other taxing jurisdiction.

As a result, more frequent royalty redeterminations by the United States are likely to precipitate more appeals by taxpayers to competent authority procedures where a tax treaty makes that available. At a minimum, it will burden taxpayers with disputing any inconsistent assessments sufficiently to avoid a further adverse effect from loss of foreign tax credits related to the foreign tax on any differences in royalty allowances.

The problem is ultimately one of difficulties of factual valuation and related difficulties of predictable and efficient tax administration. We believe that the pragmatic nature of these difficulties requires administrative flexibility in implementing the statutory standard to be adopted. For example, we believe that a fixed royalty rate should be permitted that would be applicable to either a particular intangible or possibly to all intangibles transferred by a particular taxpayer to a possession or foreign corporation with the rate to be reviewed periodically (say once every five years) on the basis of revenues for the corresponding preceding determination period. Alternatively, the rate for a particular intangible might be established once for all prior and subsequent years (prior years adjustments being included in income and expense in the adjustment year like a contingent payment) after an initial period of use of the intangible.

For the above reasons, we urge that rather than the annual redeterminations implicit in the House Ways & Means Committee Report, the Conference Committee Report indicate that the IRS is to be allowed some flexibility in how the statutory standard is to be implemented.

Sincerely yours,

Richard G. Cohen
Chairman

cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.